THE 'STATE OF THE ART' IN LIKE-KIND EXCHANGES, 2006

BY RICHARD M. LIPTON

The significant role played by the real estate industry in the current economy guarantees that issues involving Section 1031 nonrecognition exchanges will continue to be of paramount concern to practitioners. Recent guidance inevitably raises new questions, and some older issues remain unresolved. In most areas, however, practitioners have developed practical techniques that provide clients with a reasonable degree of comfort and certainty.

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Approximately six years ago, the first article on the "state of the art" in like-kind exchanges appeared in THE JOURNAL. It was followed four years later by an updated discussion of the techniques available to defer gain on exchanges of real property and other assets.[1] In the three years since, there have been considerable developments in the law.

This article focuses on the latest guidance emanating from the Service and the courts, and also addresses some of the perennial questions that always seem to arise. The matters discussed below include:

- When a taxpayer can acquire replacement property from a related party.
- Whether a taxpayer can use the reverse exchange rules to acquire property previously owned by the taxpayer or a related party.
- The state and local tax consequences of a reverse like-kind exchange.
- Leveraging before and after an exchange.
- Disposition of partnership property when some partners are willing to recognize gain and others want deferral.
- Whether a taxpayer can immediately transfer, in a nonrecognition transfer, property received in an exchange (a "swap and drop" transaction). Similarly, whether a taxpayer can exchange property received in a nontaxable distribution from a partnership (a "drop and swap" transaction) with any level of comfort.
- The tax consequences of exchanges of intangible assets, including patents, trade names, and goodwill.
- How strictly taxpayers must comply with the identification rules (the three-property, 200%, or 95% rules).
- In tenant-in-common (TIC) transactions, what aspects of the ruling requirements in Rev. Proc. 2002-22, 2002-1 CB 733, must be followed rigidly, and what aspects can be disregarded.
- Good uses of Delaware statutory trusts (DSTs) in like-kind exchange transactions, and situations in which use of DSTs is more questionable.
- The tax treatment of funds held by a qualified intermediary (QI) in a like-kind exchange.

BACKGROUND

Under Section 1031(a), no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment. Thus, there are four requirements for a tax-free exchange:

1. There must be an "exchange."
2. The "property" must be of a type that qualifies under Section 1031.
3. The replacement property must be "of like-kind" to the property relinquished.
4. Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

The general rule in Section 1031(a) requires that qualifying property must be exchanged *solely* for other qualifying property. Section 1031(b) provides, however,

that if an exchange otherwise would be eligible for tax-free treatment under Section 1031(a) but for the receipt of cash or nonqualifying property (boot), any gain realized on the exchange is recognized to the extent of the boot received.

Liabilities. Taxable boot includes relief from liabilities. Reg. 1.1031(d)-2 expressly permits a taxpayer to determine whether liabilities have been relieved using a "netting" concept. That is, the taxpayer's liabilities that are assumed or taken "subject to" by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering his relinquished property also may be offset by cash given by the taxpayer to the other party.

Basis. Like-kind exchanges result in tax deferral, not tax elimination. To preserve the deferred gain, Section 1031(d) provides that the basis of the replacement property received in a Section 1031 exchange equals the basis of the property transferred, reduced by any cash received and any loss recognized, and increased by any gain recognized. The basis of property received by a taxpayer in a like-kind exchange also may be increased by any cash paid by the taxpayer. The taxpayer's holding period for the replacement property will include the period during which the taxpayer held the relinquished property, i.e., the holding periods are tacked together.

Related parties. Under Section 1031(f), nonrecognition treatment on an exchange of property with a related person will be lost if the taxpayer or the related person disposes of either property within two years. The two-year period will be suspended under Section 1031(g) during any period in which any of the exchanged properties is subject to a put, a call, a short sale, or a transaction with similar effect.

Multiparty and deferred exchanges. While Congress probably initially intended that like-kind exchanges would apply only to simultaneous transfers between two persons, the law quickly evolved to allow both multiparty exchanges as well as deferred exchanges.

In a typical multiparty exchange, the taxpayer holds relinquished property that is sold to a buyer. The buyer in turn acquires the replacement property desired by the taxpayer. The seller of the replacement property conveys it to the taxpayer at the direction of the buyer. Although the IRS initially argued that such three-party exchanges did not satisfy Section 1031, after losing in court the Service eventually capitulated.

The fact that a transaction falls within the reverse exchange safe harbor has no impact on any other federal income tax determinations.

A significant outgrowth of the rules permitting multiparty exchanges are the Regulations allowing deferred exchanges. These exchanges are often referred to as *Starker* transactions after the Ninth Circuit decision that first sanctioned such arrangements. In *Starker*, 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979), the taxpayer transferred property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date.

Congress responded by enacting Section 1031(a)(3), which allows the transferor of the relinquished property up to 45 days to identify the replacement property and 180 days to close on the acquisition of the replacement property. The taxpayer may identify any three properties or multiple properties with an FMV not in excess of 200% of the FMV of the relinquished property. Most taxpayers prefer to use the three-property rule because of the certainty it engenders.

Much has been written about the Regulations that permit taxpayers to engage in deferred like-kind exchanges. Those Regulations set forth detailed (and generally taxpayer-friendly) guidance concerning how a taxpayer can comply with the deferred-exchange requirements in Section 1031(a)(3). Most important, the Regulations contain safe harbors that taxpayers can use to avoid constructive receipt of the proceeds from the relinquished property. These safe harbors have resulted in the creation of an entire industry—qualified intermediaries (QIs) and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under Section 1031.

Even though these rules are well established, change is possible. Previously, legislation was proposed that would, for simplification reasons, eliminate the need for QIs in like-kind exchanges. Under this legislation, a taxpayer could engage in a like-kind exchange if the taxpayer merely reinvested the proceeds of a sale of the relinquished property in replacement property within the appropriate period (similar to the rollover rule that used to apply to principal residences under former Section 1034). This approach would be simpler but also would be quite different. Only time will tell whether there will be a significant change to the rules for forward exchanges.

REVERSE EXCHANGES

Questions about a reverse exchange, which arises when a taxpayer acquires replacement property *before* disposing of the relinquished property, were answered with the issuance of Rev. Proc. 2000-37, 2000-2 CB 308.

The Service recognized that taxpayers had been using a wide variety of "parking" transactions to facilitate reverse exchanges. In the interest of sound tax administration, the IRS wanted to provide a workable means of qualifying a reverse exchange under Section 1031 if there is a genuine intent to accomplish a like-kind exchange at the time the taxpayer

NOTES

[1] Lipton, "The 'State of the Art' in Like-Kind Exchanges," 91 JTAX 78 (August 1999); Lipton, "The 'State of the Art' in Like-Kind Exchanges, Revisited," 98 JTAX 334 (June 2003).

arranges for the acquisition of the replacement property, so long as the taxpayer actually accomplishes the exchange within a short time thereafter. Accordingly, Rev. Proc. 2000-37 provides a safe harbor that allows a taxpayer to treat the exchange accommodation titleholder (EAT) as the owner of property for federal income tax purposes, thereby enabling the taxpayer to accomplish a reverse exchange.

Prior to Rev. Proc. 2000-37, reverse exchanges were usually accomplished by using an accommodation party (AP), who was required to make an investment in property in order to avoid characterization as a mere agent of the taxpayer. The investment by the AP depended on whether the transaction was structured as a swap-last exchange, in which the AP acquired and held the replacement property until the taxpayer found a purchaser for the relinquished property, or as a swap-first transaction, in which the taxpayer entered into an exchange for the replacement property immediately, and the AP acquired the relinquished property until a purchaser could be found.

The combined time period that the relinquished property and the replacement property are held in a QEAA cannot exceed 180 days.

Rev. Proc. 2000-37 does not distinguish between swap-first and swap-last transactions. Although most reverse exchanges are structured using the swap-last format (because the taxpayer may want 45 days to identify the relinquished property), the IRS did not insist that taxpayers use one or the other approach in order to achieve a nontaxable reverse exchange. Furthermore, the fact that a transaction falls within this safe harbor is taken into account solely for purposes of applying Section 1031 and has no impact on any other federal income tax determinations.

Also, the Service emphasized that no inference was intended in Rev. Proc. 2000-37 with respect to the transactions not covered by the safe harbor. Thus, the IRS specifically recognized that parking transactions could be accomplished outside of the safe harbor. If the safe harbor requirements are not satisfied, the determination of whether the taxpayer or the EAT is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by the parties, will be made without regard to the safe harbor. The IRS further indicated that no inference should be drawn with respect to parking transactions entered into prior to the Procedure's effective date.

The foundation of the safe harbor is the concept of "qualified exchange accommodation agreement" (QEAA). The IRS will not challenge the qualification of property as either replacement property or relinquished property for purposes of Section 1031, or the treatment of the EAT as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA. Property is held in a QEAA if six requirements are satisfied.

1. Ownership.
2. Intent.
3. Qualified agreement.
4. Identification.
5. Sale.
6. Timing.

Ownership. "Qualified indicia of ownership" of the property must be held (1) by an EAT who is not the taxpayer or a disqualified person (2) at all times from the date of acquisition by the EAT until the property is transferred (as described below).

The EAT must be subject to federal income tax or, if the EAT is a federal tax partnership or S corporation, more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax.

For purposes of this rule, qualified indicia of ownership includes:

- Legal title to the property.
- Other indicia of ownership of property that are treated as beneficial ownership of the property under applicable commercial law principles (e.g., a contract for deed).
- Interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (for example, a single-member LLC (SMLLC)) and that holds either legal title to the property or other indicia of ownership.

As a practical matter, in most instances this requirement will be satisfied by having the EAT either directly, or through an SMLLC, acquire legal title to the property.

Intent. At the time the qualified indicia of ownership of the property is transferred to the EAT, it is the taxpayer's bona fide intent that the property held by the EAT represents either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) under Section 1031.

Qualified agreement. No later than five business days after the transfer of qualified indicia of ownership to the EAT, the taxpayer and the EAT must enter into a written QEAA that provides that the EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37. The QEAA also must state that the taxpayer and the EAT agree to report the acquisition, holding, and disposition of the property as provided in that Procedure.

To satisfy this requirement, the QEAA must specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes, and both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the QEAA. (The practical impact of this requirement is discussed in more detail below.)

Identification. No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the EAT, the property to be relinquished must be identified in the manner set forth in Reg. 1.1031(k)-1(c) (which permits the taxpayer to identify alternative or multiple properties). Identification must be made in the manner provided in such Regulations, which presumably means that written notice must be given by the taxpayer to

the EAT as to the identity of the relinquished property by no later than midnight on the 45th day after acquisition of the replacement property. Such notice must identify the relinquished property with sufficient particularity.

Sale. No later than 180 days after the transfer of qualified indicia of ownership of the property to the EAT, either (1) the property is transferred (directly or through a QI) to the taxpayer as replacement property, or (2) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property. The transfer of the property to the taxpayer as replacement property covers a swap-last transaction, in which the EAT acquires and holds the replacement property. In contrast, the transfer of the property to an unrelated person applies in a swap-first transaction, where the AP acquires the relinquished property and holds it for later sale.

Timing. The combined time period that the relinquished property and the replacement property are held in a QEAA cannot exceed 180 days. It is not clear whether this provision also requires the taxpayer to irrevocably dispose of the relinquished property at the same time.

Doing Safe Harbor Reverse Exchanges

From a practical standpoint, the most important aspect of Rev. Proc. 2000-37 may be the flexibility that it gives to taxpayers and EATs in setting up the accommodation arrangement.

Under prior law, the AP had to have a sufficient ownership stake in the property in order for the taxpayer to avoid constructive receipt. This generally meant that the AP had to make an economic contribution to the acquisition of the property. Typically, the AP would be required to contribute at least 5%, and sometimes up to 20%, of the cost of the replacement property (or, in a swap-first transaction, the relinquished property) that the AP would acquire. The AP would demand a return on these funds, and also would want to enter into stop-loss arrangements. This usually would require the taxpayer to give the AP the right to "put" the property to the taxpayer at a price that ensured the AP made a profit on its investment.

The put given to the AP avoided the AP's risk of loss but did not ensure that the taxpayer could acquire the replacement property if the property appreciated in value. As a result, the taxpayer frequently wanted a "call" option on the property. Most practitioners were concerned that simultaneous puts and calls could result in a transfer of all of the benefits and burdens of ownership of the property to the taxpayer. As a result, in most reverse exchanges the parties were given nonsimultaneous put and call rights, which created some economic risk for both the taxpayer and the AP.

That the ownership of the property by the EAT is a mere fiction is confirmed by the fact the taxpayer can indemnify it against costs and expenses.

Moreover, any contractual relationship between the taxpayer and the AP had to be structured so as to preserve the fiction that the AP was the owner of the property. This resulted in a requirement that leases and loans bear arm's-length rents and interest rates. Likewise, although most practitioners became comfortable with the taxpayer's guaranteeing the loan used by the AP to acquire the property, some type of guarantee fee usually had to be paid. The AP could not serve as the QI in connection with a transaction involving the property, because this might make the AP into the taxpayer's agent for purposes of determining constructive receipt (even if a QI is not deemed to be a taxpayer's agent solely for the purpose of applying Section 1031 to forward exchanges).

All of these various conditions added to the risks (and the transaction costs) for reverse exchanges before Rev. Proc. 2000-37. The Procedure expressly eliminated all of these requirements. Specifically, property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's-length bargaining between unrelated parties with respect to such arrangements.

Acting as QI. An EAT that otherwise satisfies the requirements of Reg. 1.1031(k)-1(g)(4) (i.e., an EAT that is not a disqualified person with respect to the taxpayer) may enter into an exchange agreement with the taxpayer to serve as the QI in a simultaneous or deferred exchange of the property. This provision allows the title companies and exchange accommodators that have been serving as QIs to provide one-stop shopping. The same person may serve as the EAT for the acquisition of the replacement property and the QI in the sale of the relinquished property.

Loans. The taxpayer or a disqualified person may loan or advance funds to the EAT or guarantee a loan or advance to the EAT. Rev. Proc. 2000-37 does not require that the loan bear interest, or that any charge be imposed for the loan guarantee.

Furthermore, so long as the EAT is not related to the taxpayer (which would not be permitted in any event under Rev. Proc. 2000-37), no interest would be required under the OID rules in Sections 1272 and 1273 as long as the loan term is less than one year. Because the maximum term of a QEAA is only 180 days, there should be no imputed-interest problem in an interest-free loan made by a taxpayer to an EAT.

Loan guarantees. The taxpayer or a disqualified person may guarantee some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnify the EAT against costs and expenses. This addresses the practical problem that the EAT would not want to bear the risk of any environmental or tort liability. The ownership of the property by the EAT is a mere fiction, which is confirmed by this type of indemnification.

Leases. The property may be leased by the EAT to the taxpayer or a disqualified person. Rev. Proc. 2000-37 does not require that any rent (arm's-length or otherwise) be charged with respect to such lease. Accordingly, it appears that the EAT may allow the taxpayer to use the property without charge. As a practical matter, however, the taxpayer will pay rent to the EAT equal to any debt service on the loan (if any) used by the EAT to acquire the property.

Management. The taxpayer or a disqualified person can manage the property, supervise improvement of the property, act as a contractor or otherwise provide services to the EAT with respect to the property. Even though the EAT owns the property, as a practical matter the taxpayer is responsible for everything, including improvements to the property. This is particularly important in situations involving build-to-suit arrangements, in which the EAT is holding title to the replacement property while the taxpayer erects improvements on the property.

Puts and calls. The taxpayer and the EAT may enter into agreements and arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for not more than 185 days from the date the property is acquired by the EAT. This allows both the EAT and the taxpayer to assure themselves that, at the end of the QEAA, the property will be transferred by the EAT to the taxpayer.

Although Rev. Proc. 2000-37 specifically provides that puts and calls will not adversely affect a QEAA and also refers to "agreements or arrangements relating to the purchase or sale of the property," it does not refer to a binding contract of the EAT to sell the property to the taxpayer on a specific date. Because the EAT is merely serving as an accommodation titleholder, there does not seem to be any reason why such a contract would violate the intent or purpose of Rev. Proc. 2000-37.

Nonetheless, it is possible that some taxpayers may shy away from such direct purchase and sale contracts, relying instead on puts and calls. This could be a problem, however, if either party (the taxpayer or the EAT) filed for bankruptcy. In that event, a put or call could be voided by a bankruptcy court in situations in which a contract still would provide certain legal rights. It is hoped the IRS will modify Rev. Proc. 2000-37 eventually to provide that a contract to purchase and sell the property, as well as puts and calls on the property, will not adversely affect a QEAA.

Make whole. In a swap-first transaction, the EAT acquires the relinquished property from the taxpayer and (at least theoretically) is subject to risk from any changes in the value of the relinquished property. To avoid this result, the QEAA may allow the taxpayer and the EAT to enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the EAT's receipt of the property be taken into account on the EAT's disposition of the relinquished property. This "make whole" provision can be accomplished through the taxpayer's advance of funds to, or receipt of funds from, the EAT.

Other tax treatment. Property will not fail to be treated as being held in a QEAA merely because the federal income tax treatment differs from the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the EAT. Thus, although the EAT must be treated as the owner of the property for federal income tax purposes, the EAT does not have to be treated as the owner of the property for any other purposes.

State and local tax implications. Even though the federal income tax consequences of safe harbor reverse exchanges appear to be clear, the state and local consequences are much less certain.

Most of the "form" agreements that are used by EATs provide that the EAT will be treated as the taxpayer's agent for state and local tax purposes, so that any transfer of the replacement property to the EAT will be treated as a transfer of the property to the taxpayer for local real estate transfer tax purposes. This is an attempt to avoid double transfer taxes when an EAT acquires the replacement property from the taxpayer (in an swap-last transaction) or when the EAT acquires the relinquished property from the taxpayer (in a swap-first transaction). No authorities currently sanction the effectiveness of such a provision, however, and it is possible that the state and local tax agencies will attempt to impose transfer tax twice in such situations.

Although it must be treated as the owner of the property for federal income tax purposes, the EAT does not have to be so treated for any other purposes.

A related question concerns the state and local income taxation of these transactions. Rev. Proc. 2000-37 is only a safe harbor that prevents the IRS from challenging a taxpayer's treatment of a transaction—it is not a statement of substantive law. As a result, a state or local tax agency might challenge the validity of a reverse like-kind exchange by simply ignoring Rev. Proc. 2000-37 and arguing that the EAT is the agent of the taxpayer (which it usually is), so that the acquisition of the replacement property by the EAT should be viewed as an acquisition of replacement property by the taxpayer. This argument would be particularly persuasive in those jurisdictions that do not automatically incorporate all of the federal tax law interpretations. Even a state that does "piggy back" federal law could ignore Rev. Proc. 2000-37 in establishing its own litigation policy with respect to reverse exchanges.

Conversion from safe harbor to non-safe harbor. Another important practical issue concerns the likely treatment of a taxpayer who attempts to convert a safe harbor transaction into a transaction that does not comply with the safe harbor. Rev. Proc. 2000-37 clearly contemplates the possibility of a reverse exchange outside of its requirements. If, however, a taxpayer

initially acquires replacement property through an EAT, and if the taxpayer is unable to dispose of the relinquished property within the 180-day period provided in the safe harbor, can the taxpayer subsequently convert the transaction into a non-safe-harbor exchange?

Six years after the issuance of the Procedure, it remains unclear whether such conversions could be arranged. The IRS would likely argue that the EAT was the agent of the taxpayer in substance, so that if the safe harbor does not apply the acquisition of the replacement property by the EAT would be treated as an acquisition by the taxpayer, which would ruin the like-kind exchange.

Such an argument would be consistent with the Tax Court's decision in *DeCleene,* 115 TC 457 (2000), in which the court rejected a parking transaction that was not subject to the safe harbor. The Service is likely to argue that a transaction must be either wholly in or wholly outside of the safe harbor, and that a transaction cannot change from one side of the line to the other without adverse tax consequences.

Nevertheless, the taxpayer could argue that intent governs the application of Section 1031(a), and that the taxpayer's intent to engage in an exchange is not eliminated if the safe harbor is not satisfied. Suppose an EAT acquires replacement property for a taxpayer, but the taxpayer does not sell her relinquished property (and acquire the replacement property from the EAT) for 181 days. The safe harbor is not applicable because the 180-day requirement has been exceeded by one day, but that requirement is administrative, not statutory. The taxpayer would argue that her intent was always to engage in an exchange involving her relinquished property and that such an exchange occurred. Although the IRS could argue that the transaction is taxable because the EAT was the agent of the taxpayer, it is difficult to see how one day changes the nature of the underlying transaction. Thus, the taxpayer may be able to raise a strong argument that the transaction is not taxable, notwithstanding the taxpayer's failure to comply with Rev. Proc. 2000-37.

RELATED-PARTY EXCHANGES

The intersection of the rules concerning related-party exchanges and the rules concerning reverse exchanges were the focus of two of most important developments concerning Section 1031 in the past few years:

- The Service was victorious in *Teruya Brothers, Ltd.,* 124 TC 45 (2005), which addressed the treatment of acquisitions of replacement property from related parties.
- The IRS in Rev. Proc. 2004-51, 2004-33 IRB 294, narrowed the application of Rev. Proc. 2000-37 in the case of reverse exchanges involving related parties.

As noted above, Section 1031(f) provides special rules for exchanges between related parties. Under Section 1031(f)(1), a taxpayer exchanging like-kind property with a related person cannot qualify for nonrecognition under Section 1031(a)(1) if, within two years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. For purposes of this provision, related parties are defined using the rules in Sections 267(b) and 707(b).

This provision is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. The legislative history underlying Section 1031(f) states that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment and the original exchange should not be accorded nonrecognition treatment.

To prevent taxpayers from circumventing the general rule in Section 1031(f)(1), Congress also enacted Section 1031(f)(4), which provides that Section 1031(a)(1) does not apply to any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of Section 1031(f)(1). The legislative history describes a transaction under Section 1031(f)(4) as follows: If a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under Section 1031, the related party will not be entitled to nonrecognition treatment under Section 1031.

Congress also recognized, however, that not all related-party exchanges would be abusive. Accordingly, Section 1031(f)(2) provides that for purposes of applying the two-year rule in Section 1031(f)(1), dispositions in the following circumstances will not be taken into account:

- After the earlier of the death of the taxpayer or the death of the related person.
- In a compulsory or involuntary conversion if the exchange occurred before the imminence or threat of such event.
- With respect to which it is established to the satisfaction of the IRS that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax.

The legislative history of Section 1031(f)(2) notes that it is intended that the non-tax-avoidance exception generally will apply to (1) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties, (2) dispositions of property in nonrecognition transactions, and (3) transactions that do not involve the shifting of basis between properties.[2] The last exception is somewhat confusing, because under Section 1031(d) basis is always shifted in a like-kind exchange; presumably a distinction should be drawn between an abusive basis shift which avoids gain recognition and a basis shift that does not avoid gain recognition among the related parties.

NOTES

[2] H. Rep't No. 101-247, 101st Cong., 1st Sess. 1341 (1989); S. Rep't No. 101-56, 101st Cong., 1st Sess. 151-152 (1989).

In Rev. Rul. 2002-83, 2002-2 CB 927, individual A owned real estate (property 1) with an FMV of $150 and an adjusted basis of $50. Individual B owned realty (property 2) with an FMV of $150 and an adjusted basis of $150. Both properties were held for investment, and A and B were related persons within the meaning of Section 267(b).

C, an unrelated person, desired to acquire property 1 from A. A entered into an agreement for the transfers of property 1 and property 2 with B, C, and a QI that was unrelated to any of the parties. Pursuant to their agreement, A transferred property 1 to the QI and the QI then transferred property 1 to C for $150. Several days later, the QI acquired property 2 from B for $150 cash, and transferred property 2 to A in order to complete the exchange for property 1.

The IRS concluded that A was using the QI to circumvent the purposes of Section 1031(f) in the same way that the unrelated party was used to circumvent the purposes of Section 1031(f) in the example in the legislative history of Section 1031(f)(4) noted above. Absent Section 1031(f)(1), A and B could have engaged in a direct like-kind exchange of property 1 for property 2, and B then could have sold property 1 to C. This "direct" way to accomplish the transaction was barred by Section 1031(f)(1), so instead A used a transfer of property 1 to the QI in an attempt to obtain the same result without gain recognition. This series of transactions allowed A to try to cash out of property 1 without gain recognition.

Accordingly, Rev. Rul. 2002-83 concluded that A's exchange of property with the QI was part of a transaction structured to avoid the purposes of Section 1031(f) and, under Section 1031(f)(4), the nonrecognition provisions of Section 1031(a) did not apply to the exchange between A and the QI. A's exchange of property 1 for property 2 was a taxable transaction in which A recognized gain of $100.

Teruya Brothers

The impact of these rules in the context of a related-party exchange received its first serious attention in court in *Teruya Brothers*.[3]

Facts. Teruya Brothers, Ltd., a Hawaii corporation, engaged in two separate real property transactions, referred to by the Tax Court as the Ocean Vista transaction and the Royal Towers transaction.

The Ocean Vista transaction involved a parcel of land underlying the Ocean Vista condominiums in Honolulu. The property was leased by Teruya to a ground lessee which, in turn, leased the property to a condominium association that desired to acquire fee simple title to the property.

A state or local tax agency might simply ignore Rev. Proc. 2000-37 and argue that the EAT is the agent of the taxpayer (which it usually is).

Although Teruya originally refused to sell the Ocean Vista property to the association, it later agreed to sell the property provided that it was part of a like-kind exchange for a property owned by Times Super Market, Ltd. (TSM), which was owned 62.5% by Teruya. Indeed, the purchase of the replacement property from TSM, and the sale of the Ocean Vista property to the association, were mutual conditions in the contracts.

To accomplish these transactions, Teruya entered into an "exchange agreement" with T.G. Exchange, Inc. (TGE), a QI. TGE agreed to acquire the replacement property with proceeds from the sale of Ocean Vista and additional funds provided by Teruya, if necessary. On 9/1/95, Teruya sold Ocean Vista to the association for $1,468,500. Teruya's basis in Ocean Vista was $93,270. TGE used the proceeds of the sale, plus $1,366,056 provided by Teruya, to acquire a property known as Kupuohi II from TSM for $2,828,000. Because TSM had a basis of $1,475,361 in Kupuohi II, TSM recognized a gain of $1,352,639 on this sale. TGE then transferred the Kupuohi II property to Teruya.

In the second transaction, Teruya agreed to transfer the Royal Towers apartment building to Savio Development Co., conditioned on Teruya's being able to accomplish a like-kind exchange. In anticipation of this transaction, Teruya and TSM agreed that Teruya would acquire TSM's interest in two parcels of real property known as Kupuohi I and Kaahumanu. TGE was contracted as an exchange partner for purposes of these transactions.

In August 1995, Teruya transferred Royal Towers to TGE, which sold the property to Savio for $11,932,000. Teruya's basis in Royal Towers was $670,506. In exchange, TGE acquired the Kupuohi I and Kaahumanu properties from TSM for $8.9 million and $3.73 million, respectively. TSM had a basis of over $17 million in these properties and realized a loss of $6,453,372 as a result of this transaction. Because TSM and Teruya were related parties, TSM could not recognize this loss under Section 267.

Tax consequences. Teruya treated its sales of Ocean Vista to the association and Royal Towers to Savio as nontaxable like-kind exchanges. The IRS maintained that the transactions violated Section 1031(f). Although Section 1031(f)(1) did not apply to these transactions, the Service argued that the transactions were subject to the broad rule in the legislative history of Section 1031(f)(4). Specifically, the IRS relied upon the following statement in the legislative history:

"Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the re-

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[3] Also see generally Cuff, "*Teruya Brothers* and Related-Party Exchanges—How Much More Do We Know Now?," 102 JTAX 220 (April 2005).

lated party will not be entitled to nonrecognition treatment under section 1031."[4]

The taxpayer argued that this language was limited, and only applied in situations in which the taxpayer continued its investment in property that it received in a related-party deferred exchange. The Tax Court disagreed, finding the transactions were economically equivalent to direct exchanges of properties between Teruya and TSM, followed by TSM's sale of the properties to unrelated third parties. The mere insertion of a QI in these transactions did not alter their underlying tax-avoidance nature.

There is no reason that a taxpayer should not consider a non-safe harbor reverse exchange in appropriate circumstances.

The only argument left for the taxpayer was that its exchange should be entitled to nonrecognition under Section 1031(f)(2)(C), which provides an exception for any transaction in which it is established to the Service's satisfaction that neither the exchange nor the disposition had as one of its principal purposes the avoidance of tax. The taxpayer made the somewhat elliptical argument that its transactions should not be treated as having a tax-avoidance motive because an exchange—and not a sale—of the property was intended in the first place. The Tax Court disagreed because the transaction was structured so that Teruya cashed out of its investments in Ocean Vista and Royal Towers, and a related party (TSM) ended up with the proceeds of the sales. The court also considered the fact that TSM recognized substantial gain on its sale of Kupuohi II not relevant in determining whether Teruya had a tax-avoidance motive.

The important aspect of *Teruya Brothers* is that it reinforced the position that the Service had staked out in Rev. Rul. 2002-83, namely, that the acquisition of replacement property from a related party does not qualify for nonrecognition under Section 1031(a)(1) due to Section 1031(f)(4), notwithstanding that such transaction is not described in Section 1031(f)(1). As a practical matter, taxpayers and their advisors are on notice that nonrecognition will apply to related-party exchanges only if the two-year holding period requirement for both the relinquished and the replacement property is strictly complied with.

Rev. Proc. 2004-51

The other major development concerning exchanges with related parties was Rev. Proc. 2004-51, which narrowed the scope of Rev. Proc. 2000-37 with regard to reverse exchanges involving related parties.[5] In many ways, this pronouncement was an outgrowth of Ltr. Rul. 200251008, in which a reverse exchange involving related parties (and unusual circumstances) had been approved by the Service.[6]

In Ltr. Rul. 200251008, the taxpayer owned property that was under contract to be sold to a third party (the relinquished property). A related party had a long-term leasehold interest in other property. The taxpayer desired to obtain, as replacement property for its relinquished property, a leasehold position in the replacement property for a term in excess of 30 years. The taxpayer also wanted to improve the replacement property using the proceeds from the sale of the relinquished property, and it would take some time to make those improvements.

To accomplish this transaction, the taxpayer first caused the related party to convey a leasehold position in the replacement property to an SMLLC owned by an EAT pursuant to a QEAA. The taxpayer then guaranteed a loan to the SMLLC; that loan permitted the EAT to construct improvements on the replacement property according to the taxpayer's plans and specifications.

At the earlier of the completion of the improvements or 180 days, the following occurred:

1. The taxpayer sold the relinquished property to the third-party purchaser through a QI.
2. The proceeds from the sale of the relinquished property were used to acquire the SMLLC (which owned the leasehold interest in the replacement property) from the EAT.
3. The QI transferred the leasehold interest in the replacement property to the taxpayer in order to complete the exchange for the relinquished property.
4. The EAT used the money that it had received for the replacement property to pay back the loan.

Thus, when the dust settled, the taxpayer owned a long-term leasehold interest in the replacement property (fee title to which was owned by a person related to the taxpayer), and the replacement property had been improved using the proceeds from the sale of the relinquished property.

The Service concluded that this was a parking transaction between related parties but that it also satisfied all of the requirements of Rev. Proc. 2000-37. Under the safe harbor, the IRS did not challenge either (1) the qualification of property held by the EAT as replacement property or relinquished property or (2) the treatment of the EAT as the beneficial owner of property held in a QEAA. Because the replacement property was held by the EAT, the taxpayer had to be treated as acquiring the leasehold interest in the replacement property from the EAT (and not from the related person who previously owned such interest).

In Rev. Proc. 2004-51, the IRS narrowed the scope of Rev. Proc. 2000-37 to provide that it does not apply if the taxpayer owned the property intended to qualify as replacement property before initiating a QEAA. Specifically, Rev. Proc. 2000-37 will not apply to property that was owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an EAT.

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4 H. Rep't No. 101-247, *supra* note 2.

5 See Lipton, "IRS Bars Taxpayers From Building Replacement Property on Their Own Land—Or Does It?," 101 JTAX 222 (October 2004).

6 See Borden, Lederman, and Spear, "Build-to-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment," 98 JTAX 22 (January 2003).

Rev. Proc. 2004-51, however, is not inconsistent with Ltr. Rul. 200251008. In the letter ruling the replacement property was owned by a person related to the taxpayer (and not the taxpayer itself). Rev. Proc. 2004-51 does not address property that is owned by a person related to the taxpayer. On the other hand, Rev. Proc. 2004-51 indicates that the IRS is continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to the EAT and the EAT makes improvements to the land and then transfers the leasehold with the improvements to the taxpayer (i.e., the fact pattern in Ltr. Rul. 200251008). Thus, caution must be exercised before a safe harbor reverse exchange is entered into to acquire replacement property from a related party.

LEVERAGED TRANSACTIONS

The requirements of the nonrecognition rules result in different issues with respect to leveraging, depending on whether it is the replacement property being encumbered after the exchange or the relinquished property being encumbered before the exchange.

Leverage After an Exchange

A practical question that continues to arise in like-kind exchange transactions is whether the taxpayer can encumber the replacement property after the exchange and, if so, when. This leverage effectively allows the taxpayer to withdraw any equity inherent in the replacement property. Three years ago there was no definitive answer to this question, although your author then stated that there was no reason why a taxpayer could not encumber replacement property after an exchange. Indeed, your author subscribed to the theory under which a taxpayer can leverage the replacement property one nanosecond after it is acquired. Your author's views on this issue remain unchanged. Several practical points need to be considered, however.

If a taxpayer intends to leverage replacement property immediately after an exchange, the taxpayer should make certain that the debt in fact is not incurred until *after* the exchange. As a practical matter, this means that the debt financing should be evidenced by a separate closing with a separate settlement statement from the title company. Although the acquisition and the financing can occur in back-to-back transactions, the two transactions should be distinct and separate, and title to the replacement property should be clearly vested in the taxpayer before debt is placed on the property. To be certain that these timing requests are met, tax advisors frequently arrange for the debt to be placed on the replacement property the day after it is acquired.

Six years after the issuance of the Procedure, it remains unclear whether a conversion to a non-safe harbor reverse exchange could be arranged.

In addition, although a taxpayer is free to leverage property after an exchange, a different tax result could occur if the taxpayer lacks the ability to decline to borrow against the replacement property. This issue arises most frequently in "pay down, borrow back" transactions, in which the taxpayer has sold a relinquished property with significant equity and the replacement property was previously leveraged. If the amount of the debt encumbering the replacement property is not reduced, the taxpayer will not be able to invest all of the exchange proceeds in the replacement property, resulting in taxable gain.

To deal with this problem, sometimes the seller of the relinquished property will pay down the debt immediately before the exchange, with the understanding that the taxpayer will borrow back from the same lender immediately after the exchange. A "pay down, borrow back" transaction is permissible if the taxpayer is not economically forced to re-leverage the replacement property. If, however, the lender whose debt is paid down by the seller of the relinquished property would impose a significant economic penalty on the taxpayer for failing to re-leverage the property, the issue becomes whether, in substance, the debt was ever paid down at all.

In such situations the IRS could take the position that the taxpayer only invested the net amount (reduced by the debt) in the replacement property, which could result in significant gain being recognized. To avoid this potential issue, it usually is recommended that the amount payable to the lender if the taxpayer fails to re-leverage the replacement property should not exceed the amount of a customary loan commitment fee.

Leverage Before an Exchange

A more difficult question is whether the taxpayer can encumber the relinquished property immediately before a like-kind exchange. This leverage permits the taxpayer to withdraw equity from the property and also allows the taxpayer to acquire a replacement property that is subject to the same or greater leverage. There still is no definitive guidance on this issue. The limited authorities indicate that such transactions are risky, particularly if the relinquished property is encumbered immediately before the exchange.

The IRS has indicated that it may take the position that encumbering a property immediately before an exchange could result in boot to the taxpayer. In Ltr. Rul. 8434015, the Service concluded that the effect of encumbering property before an exchange was to permit the taxpayer to cash out of the property without incurring the corresponding tax for money received under Section 1031. The IRS argued that the netting rules should not be literally applied to achieve this result. In reaching this conclusion, the Service argued that *Garcia*, 80 TC 491 (1982), which permitted liability netting, could be distinguished because it involved an assumption of a debt with independent economic significance.

The logic underlying Ltr. Rul. 8434015 is questionable. It is well established that a taxpayer can encumber property without tax consequences. Furthermore, if property is encumbered and then transferred as part of a like-kind exchange, the Regu-