THE 'STATE OF THE ART' IN LIKE-KIND EXCHANGES, 2009

BY RICHARD M. LIPTON

Significant tax and non-tax advantages can arise from exchanges of like-kind assets under Section 1031. As techniques and vehicles proliferate, and IRS responds with new Regulations and rulings, practitioners must keep abreast of all of the developments.

A little more than nine 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, and by a third installment in 2006.[1] In the nearly three years since, there have been considerable developments in the law.

This article includes 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:

- What property can be exchanged.
- Reverse exchanges.
- When a taxpayer can acquire replacement property from a related party.
- 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 taxpayers can comply with the identification rules (the three-property, 200%, or 95% rules).
- In tenancy-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.
- Use of Delaware statutory trusts (DSTs) in like-kind exchange transactions.
- 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 re-

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ceipt 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 use a "netting" concept to determine whether liabilities have been relieved. 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.

Like-kind. One of the important requirements of a like-kind exchange is that the replacement property must be of "like-kind" with the relinquished property. Although the law concerning this requirement is relatively established, there have been some important recent developments.

Disregarded entities. First and foremost, it now seems clear and indisputable that entities that are disregarded for federal income tax purposes are disregarded for purposes of Section 1031, so that a transfer of all of the membership interests in a single-member LLC (SMLLC), or all of the interests in a partnership, or any other disregarded entity, to a taxpayer will be treated for purposes of Section 1031 as the acquisition of all of the property owned by that entity. This rule applies even if the taxpayer owned some of the interests in the entity immediately before the transfer; under Rev. Rul. 99-6, 1999-1 CB 432, an acquisition of all of the interests in a disregarded entity is still treated as an acquisition of property by a taxpayer.

In Ltr. Rul. 200807005, for example, the taxpayer acquired as replacement property all of the interests in a limited partnership that, as a result of such acquisition, became a disregarded entity. The IRS ruled that this transaction should be treated as an acquisition of the property owned by the partnership, even if the legal existence of the partnership survived the transaction.

On a similar note, in Ltr. Rul. 200732012, the taxpayer owned 100% of each of two disregarded entities (LLC 1 and LLC 2). The taxpayer completed a like-kind exchange by having LLC 1 dispose of the relinquished property and having LLC 2 acquire the replacement property. The IRS concluded that the taxpayer should be treated as having owned all of the property held through the disregarded entities. As a result, the acquisition of the replacement property by a legal entity (LLC 2) that did not own the relinquished property still qualified for like-kind exchange treatment.

Types of property. There also have been some recent developments concerning the types of property that qualify as replacement property in a like-kind exchange.

In *Moore,* TCM 2007-134, the taxpayers sold a vacation home and purchased another vacation home as a replacement. Neither home was ever rented to third parties. The taxpayers claimed that the vacation homes constituted property held for investment, but the Tax Court rejected this claim on the grounds that vacation property used by the taxpayer and which is not held out for rent cannot be viewed as either property held for use in a trade or business or for investment.

The IRS followed up on its victory in *Moore* by issuing Rev. Proc. 2008-16, 2008-10 IRB 547, in which the Service held that a dwelling unit (such as a vacation home) will not be challenged as relinquished property held for productive use in a trade or business or for investment if:

1. The taxpayer held the property for at least 24 months and, during each of the 12-month periods immediately preceding the exchange, the taxpayer rented the dwelling unit at fair rental value for at least 14 days, and

2. The taxpayer's usage of the property did not exceed the greater or 14 days or 10% of the number of days that the property was rented (the "minimum rental/maximum use test").

The IRS similarly stated that it would not challenge the usage of a vacation home as replacement property if it was held for at least 24 months and the minimum rental/maximum use test was satisfied.[2]

Two interesting rulings concerning the acquisition of real estate as replacement property treat intangible property as like-kind to real estate. In Ltr. Rul. 200631012, the IRS concluded that the stock in a cooperative apartment building was like-kind property to real estate because such stock was treated as an interest in real estate under local law. In Ltr. Rul. 200805012, the Service concluded that development rights were like-kind property to a fee interest. This ruling was particularly interesting because the taxpayer owned the fee title to the property in which it subsequently acquired the development rights—the development rights were treated as a separate interest in real property that the taxpayer could acquire as replacement property, even though the rights related to real estate already owned by the taxpayer.

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 in-

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[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); and Lipton, The 'State of the Art' in Like-Kind Exchanges, 2006," 104 JTAX 138 (March 2006).

[2] See Weller, Welch, and Marques, "IRS Issues Safe Harbor for Exchanges of Vacation Homes," 109 JTAX 5 (July 2008).

clude the period during which the taxpayer held the relinquished property, i.e., the holding periods are tacked.

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 running of 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.

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—QIs and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under Section 1031.

Reverse Exchanges

Similarly, much has been written about reverse exchanges, in which replacement property is acquired before the sale of the taxpayer's relinquished property. To the extent that there was uncertainty, the IRS provided very useful guidance in 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 was a genuine intent to accomplish a like-kind exchange at the time the taxpayer arranged for the acquisition of the replacement property, so long as the taxpayer actually accomplished 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 Regulations expressly permit a taxpayer to use a 'netting' concept to determine whether liabilities have been relieved.

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.

A transfer to a taxpayer of all of the interests in a disregarded entity will be treated for 1031 purposes as the acquisition of all of the property owned by that entity.

A detailed review of the rules in Rev. Proc. 2000-37 is beyond the scope of this article.[3] 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.

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 "qualified exchange accommodation arrangement" (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

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[3] See Lipton, "New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty," 93 JTAX 327 (December 2000).

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 the taxpayer or the EAT filed for bankruptcy. In that event, a put or call could be voided by a bankruptcy court, while a contract still would provide certain legal rights even in bankruptcy. 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 a 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.

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" on federal law could ignore Rev. Proc. 2000-37 in establishing its own litigation policy with respect to reverse exchanges.

In November 2007, the Pennsylvania Department of Revenue promulgated final Realty Transfer Tax (RTT) Regulations under 61 Pa. Code section 91.170. The final Regulations take the position that two realty transfer taxes are due on a safe harbor "reverse" exchange under Rev. Proc. 2000-37—one on the transfer by the seller to the EAT and a second on the transfer from the EAT to the taxpayer. Unlike most other jurisdictions that have considered the issue (e.g., Florida, Maryland, and New York City), Pennsylvania rejects the proposition that the EAT serves merely as the taxpayer's "agent" or "straw party" in connection with the exchange transaction.[4]

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[4] Pa. Reg. section 91.153(d). Pa. DOR Realty Transfer Tax Bulletin 2008-01 (1/3/08) confirms this position in its Example 6. Example 5 in the Bulletin indicates that no second RTT is due where a taxpayer merely assigns a contract right to a QI in a standard deferred exchange unless the QI takes legal title to the property.

Another interesting aspect of reverse exchanges is their impact on the identification period provided in Section 1031. In CCA 200836024, the IRS effectively concluded that taxpayer may stack the 180-day exchange period for a forward exchange with the parking period for a reverse exchange. In the transaction at issue, the taxpayer "parked" the replacement property with an EAT in a safe harbor reverse exchange on day 1, and timely identified property he would relinquish. On the 180th day the taxpayer sold his relinquished property and identified the "parked" property and other parcels as replacement property for this exchange. The taxpayer was given 180 days to acquire the other replacement property, although the property held by the EAT no longer qualified as replacement property for this relinquished property. In essence, the 180-day periods for the forward and reverse exchanges operated independently.[5]

In Ltr. Rul. 200718028, the taxpayer engaged an EAT to acquire replacement property on date 1. The taxpayer then sold the relinquished property on day 43, but did not send the EAT a formal notice identifying any potential relinquished properties until day 46 (under Rev. Proc. 2000-37, notification of the to-be relinquished property is supposed to be provided by day 45). The Service concluded, however, that the disposition of the relinquished property constituted identification for purposes of the like-kind exchange rules, so the taxpayer had until day 180 to acquire the parked replacement property from the EAT, notwithstanding that there was no other identification of the relinquished property.

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?

Nine 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 several developments concerning Section 1031 in the past few years.

As noted above, Section 1031(f) provides special rules for exchanges between related parties. Under Section 1031(f)(1), if (1) a taxpayer exchanges property with a related person, (2) nonrecognition treatment otherwise would apply to such exchange under Section 1031(a), and (3) within two years of the date of the last transfer either the taxpayer or the related person disposes of the property received in the exchange, then there is no nonrecognition of gain or loss on the initial exchange.[6] That is, the gain or loss that was deferred under Section 1031(a) must be recognized as of the date of the disposition of the property received in the exchange.

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of Section 1031(f)(1). These include any disposition (1) after the earlier of the death of the taxpayer or the death of a related person, (2) in a compulsory or involuntary conversion (within the meaning of Section 1033) if the exchange occurred before the threat or imminence of such conversion, or (3) with respect to which it is established to the Service's satisfaction that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax.

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[5] See also Letter Rulings, "Relinquished Property Could Do Double Duty in Two Like-Kind Exchanges," 109 JTAX 309 (November 2008).

[6] Section 1031(f)(3) defines a "related person" as any person bearing a relationship to the taxpayer described in Section 267(b) or 707(b)(1).

In addition, Section 1031(f)(4) provides that Section 1031(a) will not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). Thus, if a transaction is set up to avoid the restrictions of Section 1031(f), Section 1031(f)(4) operates to prevent the nonrecognition of gain or loss in such exchange.

The purpose underlying Sections 1031(f)(1) and (f)(4) was clearly laid out in the legislative history: "Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes 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....

"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 related party will not be entitled to nonrecognition treatment under section 1031."[7]

The related-party rules are then subject to an "overlay" as a result of the operational aspects of the Regulations under Section 1031. The most important of these rules allows taxpayers to use a QI to facilitate a three-party like-kind exchange. Under Reg. 1.1031(k)-1(g)(4), a taxpayer's transfer of relinquished property to a QI, and the subsequent receipt of cash by the QI on the sale of the relinquished property, is not treated as constructive receipt of such cash by the taxpayer. Instead, provided that the taxpayer timely receives like-kind replacement property from the QI, the transaction is treated as an exchange with the QI for purposes of Section 1031(a).

This rule is used primarily with respect to deferred exchanges. In such an exchange, a taxpayer who has transferred relinquished property must identify replacement property within 45 days and close on the purchase of the replacement property within 180 days of the sale of the relinquished property. Nevertheless, the QI deferred exchange Regulation generally provides a "substantive" rule that the exchange at issue is viewed as occurring between the taxpayer and the QI (and is not an exchange involving multiple parties).

Rev. Rul. 2002-83. Although the role of the QI is generally respected for purposes of Section 1031, the presence of a QI in a transaction is not sufficient to prevent the application of Section 1031(f)(4). The IRS emphasized this result in Rev. Rul. 2002-83, 2002-2 CB 927.

In that Ruling, Terry owned real property 1 with an FMV of $150 and an adjusted basis of $50. Lou owned real property 2 with an FMV of $150 and an adjusted basis of $150. Both property 1 and property 2 were held for investment, and Terry and Lou were related persons. David, an individual unrelated to Terry and Lou, wished to acquire property 1 from Terry. Terry entered into an agreement for the transfers of properties 1 and 2 with Lou, David, and a QI. Pursuant to their agreement, on 1/6/03 Terry transferred property 1 to the QI and the QI transferred property 1 to David in exchange for $150 in cash. On 1/13/03, the QI acquired property 2 from Lou, paid to Lou the $150 sale proceeds from the QI's sale of property 1, and transferred property 2 to Terry.

In the Ruling, which is somewhat similar to the facts in *Teruya Bros., Ltd.*, 124 TC 45 (2005),[8] the taxpayer would have argued that there was no violation of Section 1031(f)(1) because there was no sale of relinquished property by Lou to Terry. Furthermore, this fact pattern does not squarely fit within the language of the legislative history of Section 1031(f)(4), because there was no exchange between an unrelated party and a party related to the taxpayer.

Before the transactions occurred, however, Lou and Terry (if viewed as a single person) owned a low-basis property and a high-basis property and no cash, and after the transaction they owned a low-basis property and cash. Thus, the economic effect of this transaction is that Lou engaged in a series of transactions in which (1) low-basis property 1 was disposed of, (2) high-basis property 2 was transferred from one related party to another, and (3) one of the related parties (in this instance, Lou) received cash without gain recognition.

Section 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. The transaction in Rev. Rul. 2002-83 reached that economic result and the IRS concluded that Section 1031(f)(4) applied.

Ltr. Rul. 200706001. In Ltr. Rul. 200706001, the IRS addressed a situation involving a taxpayer, the taxpayer's three siblings, and a family trust. During his lifetime, the taxpayer's father had acquired certain timberlands, including parcels 1, 2, and 3, all of which were held for investment. After the father's death, parcel 1 was transferred to taxpayer's mother, and parcels 2 and 3 were transferred to a trust that held the parcels for the benefit of the taxpayer's mother during her lifetime, with the taxpayer and her siblings being equal remainder beneficiaries of the

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[7] H. Rep't No. 101-247, 101st Cong., 1st Sess. 1340 (1989).

[8] See also Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2006," *supra* note 1; Cuff, "*Teruya Brothers* and Related-Party Exchanges—How Much More Do We Know Now?," 102 JTAX 220 (April 2005).

trust. Subsequently, the mother transferred parcel 1, as a gift, to the taxpayer and her siblings as tenants-in-common. The per-acre tax basis of all three parcels was the same, reflecting the step-up in basis that occurred on the death of the taxpayer's father.

The trustees of the trust and the taxpayer's siblings decided to sell all of their land holdings, including parcels 1, 2, and 3, but the taxpayer did not want to sell. To address this situation, the parties agreed that the taxpayer would exchange her undivided 25% fractional interest in parcel 1 for the unencumbered fee simple interest in parcel 3. Rev. Rul. 73-476, 1973-2 CB 312, provides that exchange of an undivided interest in real estate for 100% ownership of one or more parcels of the same real estate qualifies as a valid like-kind exchange. The parties agreed that the FMV of taxpayer's 25% interest in parcel 1 was equal to the FMV of parcel 3. Shortly after the exchange, the trust and the siblings sold parcels 1 and 2 to an unrelated party.

At first blush, Section 1031(f)(1) appears to be applicable here because the taxpayer exchanged her interest in parcel 1 for parcel 3 with a related party, and the related party then sold parcel 1. This exchange met the literal terms of the statutory language. Nevertheless, there was no shifting of basis in this transaction because the per-acre basis of all of the parcels was the same (due to the step-up that had occurred on the father's death), so that the siblings recognized the same amount of gain on the sale that they would have recognized if the like-kind exchange had not occurred. Because the transaction did not involve basis shifting, the IRS concluded that Section 1031(f)(2)(C) applied, so that the like-kind exchange was given effect.

The most important aspect of Ltr. Rul. 200706001 may be that the IRS did not rigidly apply Section 1031(f)(1) when there was an exchange of properties between related parties, and one property was then disposed of. Instead, the Service looked at the purpose behind this provision, as well as the discretionary exception provided in Section 1031(f)(2)(C), and concluded that because there was no basis shifting, Section 1031(f)(1) did not apply.

Ltr. Rul. 200709036. Ltr. Rul. 200709036 involved a taxpayer that was an LLC taxable as a partnership. The taxpayer was related to a real estate investment trust (REIT), which was the sole general partner and a 90% owner of an operating partnership (OP) that, in turn, owned 99% of the taxpayer and was the managing member of the taxpayer. Thus, there was no question that the taxpayer, the OP, and the REIT were related parties.

Two interesting rulings concerning the acquisition of realty as replacement property treat intangible property as like-kind to real estate.

The taxpayer owned multiple parcels of property through separate LLCs and partnerships, including property D, which was owned through Property D LLC, a disregarded entity. Property D was substantially appreciated and had been held by the taxpayer for more than two years in its business of leasing space to tenants.

In the transaction, the taxpayer transferred all of its membership interests in Property D LLC to a related party, a taxable REIT subsidiary (TRS) owned by OP (Buyer TRS). The taxpayer entered into an agreement with an unrelated QI under which the taxpayer assigned to the QI its rights to receive all proceeds payable by Buyer TRS. The taxpayer then identified replacement property owned by an unrelated person within 45 days, and directed the QI within 180 days to acquire the replacement property (using the funds provided by Buyer TRS) and transfer the replacement property to the taxpayer. Buyer TRS anticipated selling some or all of the property acquired from the taxpayer within two years.

Again, at first blush, this transaction could be viewed as triggering the application of Section 1031(f)(1) because the taxpayer sold property to a related party (Buyer TRS), and the related party anticipated that the property would be sold within two years. The IRS concluded, however, that the taxpayer had not exchanged property with Buyer TRS but, rather, the taxpayer had exchanged property with the QI, which was not a related person. Therefore, on its face, Section 1031(f)(1) was not applicable, because there was no exchange between related persons.

The question, therefore, was whether the transaction was subject to the anti-abuse rule in Section 1031(f)(4). This provision would apply if the taxpayer and Buyer TRS could be viewed as exchanging properties either directly or through the QI and the result of the exchange was contrary to the purposes of Section 1031(f)(1). Nevertheless, Buyer TRS did not own, prior to the exchange, any property that the taxpayer acquired, so there could not have been an exchange between the taxpayer and Buyer TRS.

Furthermore, because Buyer TRS did not own any property prior to the exchange, it was not possible for the taxpayer and a related person to engage in a basis swap—there was no property held by a related party that had a basis to swap. Rather, prior to the exchange, the taxpayer owned property D, which Buyer TRS acquired by purchasing it for its FMV from the QI. Thus, there was no transaction that was structured to avoid the purposes of Section 1031(f)(1), so Section 1031(f)(4) did not apply. The subsequent sale of property D did not trigger gain recognition to the taxpayer because Section 1031(f)(1) had never applied.

The Service based its conclusion on the legislative history of Section 1031(f)(4) quoted above. Specifically, the IRS stated that Section 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. In such circumstances, the original ex-

change should not be accorded nonrecognition treatment. Where only one of the related parties owns property that is exchanged, however, Section 1031(f)(4) did not apply.

Ltr. Rul. 200712013. In Ltr. Rul. 200712013, the taxpayer owned a property (Blackacre) that had appreciated substantially in value. A party related to the taxpayer wanted to acquire Blackacre, and the taxpayer wished to transfer Blackacre to the related party in a like-kind exchange. Because the related party did not own any like-kind assets that the taxpayer wished to acquire, the taxpayer entered into an agreement with an unrelated third party under which the third party agreed to sell a replacement property, Whiteacre, to the taxpayer. The replacement property was acquired by the taxpayer using a "reverse exchange" under Rev. Proc. 2000-37, in which the taxpayer provided all of the funds needed by an EAT to acquire Whiteacre.

After the taxpayer had funded the acquisition of Whiteacre through the EAT, the taxpayer entered into an agreement with the related party pursuant to which the taxpayer agreed to transfer Blackacre to the related party in exchange for cash. The taxpayer then assigned its sale contract to a QI, which transferred Blackacre to the related party for cash and then used the cash to complete the reverse exchange for Whiteacre. Thus, when the dust settled, the taxpayer owned Whiteacre with a carryover basis and the related party owned Blackacre with a basis equal to its FMV. The related party stated that it intended to dispose of Blackacre within two years.

The IRS accepted the taxpayer's representations in its request for a ruling that acquisition of Whiteacre through a reverse exchange under Rev. Proc. 2000-37, as well as the disposition of Blackacre through a forward exchange with the related party, ostensibly satisfied the requirements of Section 1031(a). Accordingly, the IRS viewed the issue as whether nonrecognition treatment would apply to a transaction where (1) the taxpayer purchased like-kind replacement property from an unrelated third party via an EAT, (2) the taxpayer sold relinquished property to a related party for cash (through a QI), and (3) the related party then disposed of the relinquished property within two years of the acquisition.

The IRS concluded, first, that Section 1031(f)(1) was not applicable in this situation because the taxpayer and the related party did not enter into an exchange. Instead, taxpayer transferred the relinquished property (Blackacre) to the QI, which also transferred the replacement property (Whiteacre) to the taxpayer through the reverse exchange. Thus, the exchange was treated as occurring between the taxpayer and the QI, who were not related parties.

IRS did not insist that taxpayers use either the swap-first or swap-last approach in order to achieve a nontaxable reverse exchange.

The more important question was whether Section 1031(f)(4) would apply in this situation, as it had in Rev. Rul. 2002-83. Again, the IRS concluded that Section 1031(f)(4) was inapplicable. Specifically, the IRS stated that the taxpayer did not transfer Blackacre to a related party as part of a transaction or series of transactions structured to avoid the purposes of Section 1031(f)(1). The related parties in this transaction did not exchange high-basis property for low-basis property in anticipation of the sale of the low-basis property. Only the taxpayer held property before the reverse like-kind exchange, and the taxpayer continued to hold like-kind property after the exchange. The related party did not hold property before the exchange, so there was no "shifting" of the basis of property between the taxpayer and the related party. As a result, the sale of Blackacre by the related party did not trigger gain recognition.

This situation needs to be distinguished from Rev. Rul. 2002-83, in which immediately before the exchange the related party held high-basis property and the taxpayer held low-basis property. Technically Section 1031(f)(1) did not apply in that ruling, either, because the taxpayer exchanged with the QI rather than the related party. Nevertheless, because the related party disposed of the property it acquired from the taxpayer, the effect of the transaction in the Revenue Ruling was that basis was "shifted" from the high-basis property owned by the related party to the low-basis property formerly owned by the taxpayer. As a result, Section 1031(f)(4) applied in Rev. Rul. 2002-83 but not in Ltr. Rul. 200712013.

Moreover, in Rev. Rul. 2002-83, collectively the related parties engineered a transaction in which the low-basis property was sold, the high-basis property previously owned by a related party was retained, and the related parties ended up holding cash (that they did not previously have) and not having gain recognition. This was effectively the same transaction as described in Section 1031(f)(1), except that the order of the steps was reversed.

By contrast, in Ltr. Rul. 200712013, while the low-basis property held by the taxpayer was sold, there was no high-basis property owned by a related party prior to the exchange. All that happened in substance in the letter ruling was that the taxpayer sold its property (Blackacre) and acquired replacement property (Whiteacre) from an unrelated person. The transfer of Blackacre to a related party did not alter the underlying economics, in that there was no "cashing out" in the transaction with respect to low-basis property. Specifically, Buyer TRS had cash before it acquired Blackacre, and it had cash again when Blackacre was sold, so there was no use of high-basis property in order to obtain cash on the sale of low-basis property.

Summary. In all three of the rulings concerned with related-party involvement in Section 1031 exchanges, it appears that the IRS reached the

correct conclusion. Moreover, the Service did not apply Section 1031 (f)(4) in situations in which there was no basis shifting between high-basis property and low-basis property. Instead, the IRS limited the application of Section 1031(f)(4) (and Rev. Rul. 2002-83) to situations in which related parties, either directly or through a QI, used an exchange of high-basis property for low-basis property to obtain the benefit of the high basis on a cash sale of the low-basis property. This limitation appears to be appropriate, but prior to these rulings it was unclear whether the IRS would so limit the application of Section 1031(f)(4).

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.

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 might 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 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 Service 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 IRS 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 Regulations are clear that the transferor will recognize gain unless an equal or greater amount of debt encumbers the replacement property received in the exchange. Thus, from a before-and-after perspective the taxpayer's liabilities will not be

reduced as a result of a like-kind exchange.

Moreover, analytical support for the conclusion that no gain is recognized merely because property is encumbered before a like-kind exchange can be found in the Regulations under Section 707(a)(2)(B), relating to disguised sales between partners and partnerships. In general, Section 707(a)(2)(B) requires a taxpayer to recognize gain or loss if (1) property is transferred to a partnership, (2) the transferor receives a distribution of money or other property from the partnership, and (3) the effect of the transaction is a sale.

The taxpayer may indemnify the EAT against costs and expenses to solve the practical problem that the EAT might face environmental or tort liability.

The Section 707(a)(2)(B) Regulations recognize that the economic equivalent of a sale could be obtained if a taxpayer encumbers property a short time before the property is transferred to the partnership. Accordingly, the Regulations provide that if property is transferred to a partnership subject to a nonqualified liability, or if the nonqualified liability is assumed by the partnership, the transaction is treated as a cash distribution to the transferor to the extent that the transferor's share of the liability is reduced.

The important aspect of the partnership rule in this context is that there are no tax consequences under Section 707(a)(2)(B) if, and to the extent that, the transferor's share of the liability is not reduced. Thus, if Harry encumbers Greenacre with $1 million of debt immediately before transferring Greenacre to a partnership, Harry will have no tax consequences as long as he is allocated at least $1 million of the partnership's debt after the transfer.

Logically, the same result should apply in Section 1031 exchanges. Thus, a taxpayer should be able to encumber the relinquished property immediately before a like-kind exchange *if* the replacement property received in the exchange is encumbered by an equal or greater liability. In that situation, although the taxpayer has "monetized" her property, she has done so by increasing her debt, which is not a taxable event.

LIKE-KIND EXCHANGES INVOLVING PARTNERSHIPS

The most frequently encountered problem in like-kind exchanges may involve the treatment of partnerships that own the relinquished property. It is exceedingly common when a partnership sells its property that one or more of the partners want to cash out in the transaction, whereas other partners want to reinvest through a like-kind exchange.

EXAMPLE: Jack, Karen, Luke, and Mary are equal partners in partnership JKLM, the only asset of which is Whiteacre, a rental apartment building worth $10 million. Jack inherited his interest from his recently deceased parent, and Karen contributed $2.5 million to JKLM (which the partnership used for capital improvements) for her interest, so they each have a stepped-up basis in their partnership interests. Luke and Mary have a zero basis in their interests. JKLM made a Section 754 election, so the partnership has a $5 million basis in Whiteacre.

A buyer has offered to purchase Whiteacre for its FMV of $10 million, and all of the partners want to sell. Jack and Karen either want to cash out with their share of the proceeds of the sale or, at a minimum, separate from the other partners, but Luke and Mary want JKLM to purchase replacement property so as to defer gain recognition.

If JKLM sells Whiteacre to the buyer and half of the proceeds are given to a QI and half are received by JKLM in cash (for distribution to Jack and Karen), the partnership will recognize $5 million of gain on the transaction, because gain is recognized to the extent of the boot received ($5 million in cash). If this gain were allocated equally to all of the partners, Luke and Mary would each recognize $1.25 million of gain but receive none of the cash; needless to say, this result would not be acceptable.

There are at least five alternatives for resolving this situation:

- Special allocations.
- Distribution of undivided interests.
- Installment notes.
- Purchase of interests.
- Coordinated like-kind exchanges.

Special Allocations

Some partnerships have attempted to use a special allocation of the gain to the partners who cash out, i.e., the $5 million gain would be allocated to Jack and Karen. This gain would increase their basis in their partnership interests, so Jack and Karen also would have offsetting capital losses on the receipt of $2.5 million each from JKLM in redemption of their interests. (Of course, if any of the gain reflects depreciation recapture, Jack and Karen would have ordinary income and capital losses, which would not offset, resulting in adverse tax consequences.)

The potential problems with this approach were highlighted in a decision of the California State Board of Equalization (SBE). In *Appeal of Ahlers,* Cal. St. Bd. Eq. No. 257852, 12/13/05, 2005 WL 3530147, the SBE addressed a situation in which a partnership called Terra Nova Associates (TNA) attempted to allocate specifically to certain of its partners the gain from a like-kind exchange in which boot was recognized. The partnership had sold property and boot was received in the exchange; each partner was permitted to participate (or not) at its own discretion in a like-kind exchange. The taxpayer contended that the special allocation of gain contained in the partnership agreement for TNA was

effective to shift the gain to one of the partners.

The SBE rejected the taxpayer's argument on the grounds that the special allocation of income did not have substantial economic effect under Section 704(b). The taxpayer was not even able to contend that the allocations met the safe harbor in Reg. 1.704-2(b)(2). Instead, the taxpayer had to argue that the allocations were consistent with the partners' interests in the partnership, which the taxpayer further contended should be determined on the basis of the exchange of the partner's interest for other property. The SBE rejected this contention, however, concluding that all income had to be allocated to the partners in accordance with their percentage interests, without regard to the special allocations.

Distribution of Undivided Interests

Assuming that the gain cannot be specially allocated to the cash-out partners, many partnerships have distributed undivided TIC interests in the property to their partners immediately before the sale. In our example, JKLM would distribute a 25% undivided interest in Whiteacre to Jack and Karen in redemption of their interests immediately before the sale, while Luke and Mary would remain partners in the partnership. Alternatively, undivided interests could be distributed to all of the partners in liquidation of the partnership immediately before the sale to the buyer. Three issues arise:

1. Do the partners satisfy Section 1031's "held for use in a trade or business or for investment" test if they receive their undivided interests immediately before the sale?

2. Notwithstanding the dissolution of JKLM, does the relationship between the partners constitute a deemed partnership under Section 761, particularly if there is a significant level of activity involved in the operation and management of Whiteacre? And if the level of activity is minimized by reducing the time that the property is held by the (former) partners as tenants in common, does that undercut their position with respect to the first issue?

3. The most important issue concerns the timing of the transfer of the undivided interests in the property. Did the partnership previously sign a contract to sell the property? If it did, then the IRS could argue, relying on *Court Holding Company,* 324 U.S. 331, 33 AFTR 593 (1945), that the transaction must be viewed as a sale of the property by the partnership, the intervening distribution notwithstanding. The level of risk in this transaction increases dramatically if the sale contract was signed before the distribution occurred. Nevertheless, many practitioners are comfortable that *Court Holding* does not apply if undivided interests in the property are distributed to the partners and, immediately thereafter, the partners sign individual contracts to sell their interests to the purchaser (these events usually occur on the same day or, at most, one day apart).

No authorities clearly confront these questions. With respect to the first issue, if Luke and Mary keep the partnership alive, there seems to be no question that the JKLM partnership satisfies the "held for" test. Even if JKLM is liquidated immediately before the sale, however, several analogous authorities indicate that the "held for" standard would be satisfied. (These issues are discussed in detail, below, in connection with the tax treatment of "drop and swap" transactions.)

In *Magneson,* 753 F.2d 1490, 55 AFTR2d 85-911 (CA-9, 1985), *aff'g* 81 TC 767 (1983), a taxpayer exchanged investment property for other like-kind property, and immediately thereafter contributed the replacement property to a partnership in exchange for a 10% general partnership interest. The court concluded that holding the property for contribution to the partnership was holding it for investment, and that the ownership of property as a general partner was not substantially different than direct ownership of the property. Similarly, in *Bolker,* 760 F.2d 1039, 56 AFTR2d 85-5121 (CA-9, 1985), *aff'g* 81 TC 782 (1983), the court permitted a like-kind exchange by a shareholder of a corporation who received the relinquished property immediately before the exchange through a nontaxable liquidation of the corporation.

The problem is that these authorities are not completely on point, particularly because only rarely will the partners (or more commonly now, the members of an LLC) be general partners in a partnership. Furthermore, *Magneson* was decided when a tax-free exchange of partnership interests was permissible under Section 1031; Section 1031(a)(2)(D) altered that rule. Thus, there is at least some room for doubt that the "held for" requirement has been met if the partnership is liquidated.

The second issue also is a puzzling one. Logically, the distribution of undivided interests in the property should not result in a continuation of a partnership, but the broad definition of an "entity" could pick up co-ownership of actively managed property. In some situations, this risk has been minimized by net-leasing the property to a master lessee, but this planning step is not always available. If such a net lease is not used, the determination of whether the partnership has remained in existence probably will depend on the facts and circumstances of the situation.

The lack of precedent notwithstanding, it is probably fair to say that this is the methodology most frequently used to deal with the common situation in which some partners want to reinvest and other partners want to cash out. There does not appear to be any policy reason why this transaction should be taxable to the reinvesting partners. After all, in our example Luke and Mary owned (through the partnership) an interest in real estate before the transaction, and they will own an interest in real estate (either directly or through the partnership) after the transaction. Why should they be subject to taxation when their economic position has not changed? For this reason, many advisors have used this arrangement,

although the more cautious ones have described to their clients the risks involved (and, when possible, kept the partnership alive for the partners who want like-kind exchange treatment).

In a properly structured transaction, the undivided interests will be distributed before any contract is signed to sell the relinquished property. If the sale contract already has been signed, a practitioner needs to know (and advise her client) that the risk is substantially greater and that the transaction might be challenged. Indeed, the "planning rule" for transactions in which an undivided interest in property is to be distributed to a partner should be that such transactions can be undertaken by distributing the undivided interests in the relinquished property to the cash-out partners before signing a contract of sale. At that point, each of the co-owners can independently determine whether or not it wishes to sell, which buttresses the argument that the distribution should be treated as separate from the sale.

It also is important in this transaction to "do what you say you are doing." In many situations, a partnership will own property that it wishes to sell, and it enters into an agreement to distribute undivided interests in the property to its partners who do not want to do an exchange, but then the partnership does not actually make the distribution in order to avoid transfer taxes or lender notification requirements. Although some of the paperwork concerning the distribution will be executed by the partnership, the notification and recording of the transaction with third parties will not occur. The failure to "do what you say you are doing" is very troubling and would give the IRS a strong argument that the alleged distribution of undivided interests in the property should be disregarded. In that event, the partnership will be deemed to have received the cash paid for the property, and the exchanging partners will likely recognize gain as a result of the deemed receipt of boot.

Installment Notes

The third alternative is commonly referred to as the "installment note" method. Under this approach, the buyer conveys to the seller cash to be used for the purchase of the replacement property plus an installment note that could be distributed to the cash-out partners in liquidation of their interests.

Applying this method to our example, the buyer would convey to JKLM, in exchange for the relinquished property, cash of $5 million (which would be paid to a QI) plus an installment note for $5 million. The note typically would provide for 98% or 99% of the payments thereon to be made a short time after closing, with the remaining payments to be made after the beginning of the next tax year, thus qualifying for installment reporting under Section 453(b)(1). If the buyer is credit-worthy, no other assurances of payment might be needed; if there are questions concerning the buyer's financial ability to satisfy the note, a standby letter of credit might be obtained by the parties.

This method works because no gain or loss is recognized by JKLM on receipt of the installment note (although there are certain exceptions to nonrecognition under Section 453, such as sales of inventory and depreciation recapture). Furthermore, the distribution of the installment note to Jack and Karen in redemption of their interests in JKLM also should not result in recognition of gain under Sections 453 and 731.

Instead, Jack and Karen would recognize gain only as payments are received on the note. JKLM, now comprising only the remaining two partners (Luke and Mary), would purchase replacement property, which clearly would qualify for tax deferral under Section 1031 because the partnership had held the relinquished property and acquired the replacement property.

What if the buyer is unwilling to issue its note, or the seller of the property is unwilling to accept the buyer's note (even if the note is backed by a standby letter of credit)? In that event, it is important to consider that the party with whom the taxpayer is engaging in an exchange is the QI (and not the ultimate buyer of the relinquished property). Therefore, the taxpayer could accomplish the same result by receiving an installment note from the QI. Provided that this note is not collateralized by cash or other liquid assets, the QI's note is just as effective as a note from the buyer, and it often will be easier to arrange for.

Partner Buy Out

What if a partnership is not able to distribute undivided fractional interests to its partners before signing a sale contract (or is unwilling to actually record the transfer for transfer tax reasons), and the installment note transaction cannot be engineered for one reason or another? In that situation, the partners who desire to complete the exchange should consider buying the interests of the cash-out partners immediately before the exchange.

Theoretically this purchase can occur on the same day as the sale of the relinquished property by the partnership, provided that it is clearly documented that the cash-out partners sold their interests before the partnership sold the property. In most cases, however, the purchase occurs a day or two before the sale so as to clearly establish that the partnership interest was acquired prior to the sale of the relinquished property. The partnership then can complete the exchange and reinvest the sale proceeds in replacement property.

Of course, the remaining partners must come up with the cash to acquire the interest of the departing partners, which may not be simple, particularly before the sale of the relinquished property. As an alternative, the partnership could redeem the interests of the departing partners in exchange for a note that encumbers the relinquished property. The purchaser of the replacement property can then satisfy that note as part of the consideration for the sale.

Although the remaining partners (through the partnership) would need to purchase replacement property that includes the amount paid to the departing partners, this technique would provide the cash needed to buy out the departing partners' interests.

Coordinated Like-Kind Exchanges

In some instances, the partners are willing to engage in like-kind exchanges but cannot agree on the replacement property to be acquired.

EXAMPLE: Partnership RST owns Blackacre (the relinquished property), which is to be sold for $300. Partners R, S, and T each want to engage in a like-kind exchange, except that R wants to acquire only Redacre, S wants to acquire only Silveracre, and T wants to acquire only Tealacre—and none of the partners is willing to be flexible in this regard. Each of the properties desired as replacement property costs $200.

In this situation, RST could sell Blackacre and form three separate SMLLCs—one for acquiring Redacre (RLLC), one for Silveracre (SLLC), and one for Tealacre (TLLC). R, S, and T can be appointed as the managing members of RLLC, SLLC, and TLLC, respectively. Moreover, because the proceeds of the sale of Blackacre ($300) are insufficient to pay for the purchase of all three replacement properties, R, S, and T can each lend $100 to RLLC, SLLC, and TLLC, respectively (or they can guarantee the loans used by each entity to acquire its replacement property). After a significant holding period, the partnership could dissolve, distributing RLLC to R, SLLC to S, and TLLC to T.

This transaction works, however, only if the partnership (RST) is the tax owner of the replacement properties acquired through the newly formed LLCs. To achieve this result, the partners (R, S, and T) have to continue to share in the economic performance, as well as the appreciation and depreciation, of each of the properties owned by RST. The partners will likely seek special or tracking allocations of the income and gain from the properties; this urge needs to be resisted so as to give each of the partners a real economic interest in all of the properties owned by RST.

DROP AND SWAP; SWAP AND DROP

A frequently encountered pair of questions relating to partnerships and Section 1031 transactions are whether a taxpayer can exchange property received in a distribution from a partnership (a "drop and swap" transaction), and whether a taxpayer who receives replacement property in an exchange can immediately transfer the property to a partnership (a "swap and drop" transaction).

Drop and Swap Transactions

The issue (discussed briefly above in connection with partnership transactions) is whether a transfer of the relinquished property from a partnership to the taxpayer immediately before an exchange violates the "held for" requirement under Section 1031 (a)(1).

The requirement applies to both relinquished and replacement properties. The statutory language, however, does not indicate explicitly whether the acquisition of relinquished property in a nonrecognition transaction immediately before a like-kind exchange would disqualify the subsequent exchange from nonrecognition treatment. Because Congress has remained silent on this issue, taxpayers have been left to rely on holdings by the IRS and the courts.

IRS position. In several Rulings, the IRS has considered whether property acquired prior to a like-kind exchange satisfies the "held for" requirement under Section 1031(a)(1).

In Rev. Rul. 75-291, 1975-2 CB 332, corporation Y entered into a written agreement to acquire land and a factory owned by unrelated corporation X. Pursuant to this agreement, Y acquired another tract of land and constructed a factory on this land, and then exchanged the land and new factory for X's land and factory. Because Y acquired the property transferred to X "immediately prior to the exchange," the Service concluded that Y "did not hold such [relinquished] property for productive use in its trade or business or for investment." Thus, as to Y, the exchange did not qualify for nonrecognition of gain or loss under Section 1031(a).

Rev. Rul. 77-297, 1972-2 CB 304, involved taxpayer A, who agreed to sell a ranch with the stipulation that the buyer (B) would cooperate to effectuate an exchange of properties should A locate suitable property. Once A located another ranch, owned by C, B purchased C's ranch and then exchanged this ranch with A for A's ranch. With regard to B, the IRS concluded that the exchange of ranches did not qualify for nonrecognition of gain or loss under Section 1031 because "B did not hold the second ranch for productive use in a trade or business or for investment." In reaching this conclusion, the Service cited Rev. Rul. 75-291, in which "it is held that the nonrecognition provisions of section 1031 do not apply to a taxpayer who acquired property solely for the purpose of exchanging it for like-kind property."

In Rev. Rul. 77-337, 1977-2 CB 305, the Service considered whether property acquired immediately prior to a like-kind exchange, through the liquidation of the taxpayer's wholly owned corporation, could satisfy the "held for" requirement. Individual A was the sole owner of the stock of corporation X, which owned a shopping center. Under a prearranged plan, A first liquidated X and thereby acquired the shopping center. Immediately after the liquidation, A transferred ownership of the shopping center to an unrelated party in exchange for like-kind property. The IRS reasoned, without elaboration, that the "productive use of the shopping center by X prior to the liquidation cannot be attributed to A." As a result, the Service concluded that A's ownership of the relinquished property was insufficient to satisfy the

"held for" requirement under Section 1031(a)(1).

In Ltr. Rul. 8414014, the IRS temporarily recognized that the holding of relinquished property by one consolidated group member could be attributed to another consolidated group member for purposes of the "held for" requirement. The IRS revoked Ltr. Rul. 8414014 after only eight months (without discussion of its reasoning), so this ruling should not be viewed as an example of the Service's current position on the "held for" requirement in the consolidated group context. Nonetheless, this ruling demonstrates that the IRS has at least considered the possibility that the holding of property by one entity may be attributed to another entity in the "held for" analysis.

Ltr. Rul. 8414014 involved a consolidated group of corporations that operated telephone companies. In order to consolidate its operating territories, the group's parent (W) proposed, in part, to transfer all of the group's operating assets in states A and B to an unrelated corporation in exchange for operating assets located in state D. Prior to this transfer, W would cause one of its subsidiaries (X) to merge into a newly formed subsidiary (Newco) organized in state D and also included on W's consolidated return. W would then cause another one of its subsidiaries (Y) to pay as a dividend to W all of its state A assets, and W would then transfer these assets to Newco in exchange for stock or securities. After these steps, Newco would exchange its state A and B assets for the state D assets of the unrelated corporation.

Based on these facts, the IRS considered whether the use of property in a trade or business by one member of an affiliated group that files a consolidated return is "attributable to another member of the group to whom the property is transferred." The Service acknowledged that Rev. Rul. 77-337 "arguably" could preclude the application of Section 1031 to this exchange because Newco would acquire the relinquished property and immediately exchange such property. Nevertheless, the IRS concluded—at least until the revocation of this ruling—that the facts in Ltr. Rul. 8414014 were distinguishable from Rev. Rul. 77-337 because the state A assets "have been used in [a] trade or business by Corp. Y, another member of the Corp. W affiliated group."

Thus, pursuant to the "single economic entity theory of the consolidated return regulations," under which the individual members of a consolidated group are treated as divisions of the same economic entity, the IRS ruled that the use of the state A assets in a "trade or business within the affiliated group is attributable to Newco," and Newco's exchange of assets with the unrelated corporation would qualify for nonrecognition under Section 1031.

Once again, Ltr. Rul. 8414014 has minimal, if any, relevance because it was revoked by the IRS after only eight months. Despite this fact, Ltr. Rul. 8414014 reveals that, at least in the past, the Service has been undecided on the issue of whether the use of property by one entity may be attributable to another entity in the context of the "held for" requirement under Section 1031(a)(1).

In Ltr. Rul. 9751012, the IRS again considered whether the use of relinquished property by one entity could be attributed to another entity. In this ruling, a taxpayer's two wholly owned subsidiaries and affiliate each transferred relinquished properties to a QI, pursuant to Reg. 1.1031(k)-1(g)(4). Following this transfer, and before the transfer of replacement properties, (1) the taxpayer liquidated its two subsidiaries under Section 332, and (2) the taxpayer's parent merged the affiliate into the taxpayer under Section 368(a)(1)(A). After these steps, the taxpayer organized wholly owned SMLLCs to hold each replacement property. The taxpayer requested a ruling that, in part, it would be treated as both the transferor of the relinquished properties and the transferee of the replacement properties in a like-kind exchange of such properties pursuant to Section 1031(a).

The IRS focused its analysis on whether, under Section 381(a), the tax attributes of the taxpayer's liquidated subsidiaries and merged affiliate with regard to the relinquished properties would carry over to the taxpayer. Section 381(a) generally provides that, in the event of the acquisition of the assets of a corporation by another corporation (which includes transactions under Section 332 and Section 368(a)(1)(D)), the acquiring corporation succeeds to and takes into account, as of the close of the day of distribution or transfer, the items of the transferor described under Section 381(c).

Because Section 381(c) does not specifically refer to like-kind exchanges, the IRS reviewed the legislative history of Section 381 to determine whether an entity's use of property for purposes of Section 1031 should carry over to its successor corporation. Quoting from a portion of this legislative history, the IRS pointed out that the purpose of Section 381 was "to enable the successor corporation to step into the 'tax shoes' of its predecessor corporation without necessarily conforming to artificial legal requirements which [then existed at the time of its enactment] under court-made law." The IRS also found no language in this legislative history to suggest that "the tax attributes listed in section 381(c) [should] be the exclusive list of attributes available for carryover."

Based on this broad reading of Section 381, the Service treated the taxpayer in Ltr. Rul. 9751012 as if it stepped into the "tax shoes" of its liquidated subsidiaries and merged affiliate for purposes of Section 1031. Under this approach, the transfer of the relinquished properties by the taxpayer's subsidiaries and affiliate was attributed to the taxpayer. Accordingly, the taxpayer—and not its subsidiaries and affiliate—was treated as the transferor of the relinquished properties in a like-kind exchange for the replacement properties.

Although private letter rulings may not be used or cited as precedent, Ltr. Rul. 9751012 is significant because—unlike Ltr. Rul. 8414014—it demonstrates a clear recognition

by the IRS that the use of property by one entity may be attributable to another entity for purposes of Section 1031.

One final inference can be drawn concerning the Service's view of this question. In Rev. Proc. 2002-22, section 6.03, the IRS stated that it generally will not issue a ruling if the co-owners held interests in the property through a partnership or a corporation immediately prior to the formation of the co-ownership. Thus, the Service generally will not issue a ruling that a co-tenancy will be treated as the ownership of real estate if it is part of a proposed drop and swap transaction.

This curious statement could be read two ways. It could be viewed as the IRS continuing to draw a line in the sand that drop and swap transactions are impermissible. Alternatively, this statement could be viewed as a recognition by the Service that taxpayers regularly transfer property out of a partnership immediately before an exchange, and the IRS is simply not willing to state that there is no continuation of the partnership if the transferred interest is only an undivided fractional portion of the partnership's property. The latter view would be more consistent with the overall scope and purpose of Rev. Proc. 2002-22, which is intended to delineate when commonly owned property does not give rise to a partnership.

The Tax Court and Ninth Circuit. In *Bolker,* both the Tax Court and the Ninth Circuit rejected the Service's position, as set forth in Rev. Rul. 77-337, that property acquired prior to a like-kind exchange through the liquidation of a taxpayer's wholly owned corporation did not satisfy the "held for" requirement under Section 1031(a)(1).

Pursuant to an exchange agreement, the taxpayer ultimately exchanged his newly acquired property for other real property. Although the taxpayer caused the liquidation of his corporation under former Section 333 and entered into an exchange agreement on essentially the same date, the exchange was not effectuated—and the taxpayer did not give up ownership of the relinquished property—until more than three months later.

The Tax Court concluded that the taxpayer's ownership of the relinquished property satisfied the "held for" requirement because (1) the taxpayer acquired the relinquished property in a tax-free transfer under old Section 333 and (2) the taxpayer held an economic interest in the relinquished property prior to such liquidation, and this interest was maintained after the liquidation and subsequent exchange of the property. In reaching its decision, the court referred to its reasoning in *Magneson,* which (as described in greater detail below) recognized that a taxpayer's post-exchange transfer of replacement property to a partnership under Section 721 did not violate the "held for" requirement. Because the taxpayer in *Magneson* did not hold the replacement property for sale, personal use, or for transfer as a gift, the Tax Court ruled that the holding of property "for a nontaxable contribution to a partnership under section 721 qualified as a holding for investment purposes under section 1031."

According to the Tax Court, *Magneson* entitled the taxpayer in *Bolker* to relief because in *Magneson* the exchange of properties was immediately followed by a tax-free Section 721 transfer; in *Bolker* the exchange of properties was immediately preceded by a tax-free acquisition under Section 333. In the view of the Tax Court, "[t]hat the tax-free transaction preceded rather than followed the exchange is insufficient to produce opposite results." In other words, the tax-free acquisition of relinquished property prior to an exchange—like the tax-free transfer of replacement property after an exchange—did not constitute the sale, conversion to personal use, or transfer as a gift of such property and, therefore, did not violate the "held for" requirement.

The Tax Court concluded further that, even aside from *Magneson,* the taxpayer's pre-exchange acquisition of the relinquished property satisfied the "held for" requirement because the taxpayer maintained a continuing economic interest in the relinquished property. In the taxpayer's liquidation of his wholly owned corporation under old Section 333, the court observed, the taxpayer surrendered stock in his corporation for real estate owned by the corporation, and continued to have an economic interest in essentially the same investment, although there was a change in the form of ownership.

As evidence of this continuity of ownership, the Tax Court pointed to the fact that the taxpayer's basis in the real estate acquired on liquidation equaled his basis in the stock surrendered, and the gain realized was not recognized but deferred until gain on the continuing investment was realized through a liquidating distribution. In short, the Tax Court concluded, "Section 333 recognizes the taxpayer's continuing investment in the real estate without the interposition of a corporate form." Thus, provided that a taxpayer exchanges the relinquished property for like-kind property and holds the replacement property for qualifying purposes under Section 1031(a), the taxpayer's exchange should qualify for nonrecognition treatment under Section 1031.

Although the Ninth Circuit affirmed the Tax Court's decision in *Bolker,* the appellate court established a more liberal interpretation of the "held for" requirement. According to the Ninth Circuit, the Service's position, as set forth in Rev. Rul. 75-291, Rev. Rul. 77-297, and Rev. Rul. 77-337, "would require us to read an unexpressed additional requirement into the statute that the taxpayer have, previous to forming the intent to exchange one piece of property for a second parcel, an intent to keep the first piece of property indefinitely."

The court rejected the Service's interpretation of the "held for" requirement, and instead held "that if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in trade or business or for investment'

within the meaning of section 1031(a)."

The court continued that the "intent to exchange property for like-kind property satisfies the holding requirement because it is not an intent to liquidate the investment or to use it for personal pursuits." Under this rule, the taxpayer's pre-exchange acquisition of the relinquished property in *Bolker* satisfied the "held for" requirement—regardless of whether this acquisition was a nonrecognition transaction—because the taxpayer acquired this property with an intent to undertake a like-kind exchange with such property.

Practical advice. Where do all of these conflicting authorities leave us? What seems fairly clear is that the courts have not accepted the Service's contention that a "drop and swap" transaction is impermissible. Likewise, based on the private rulings that have been issued, it is not completely clear that the IRS itself believes that such transactions must be taxable. Unfortunately, there is no recent, clear guidance that specifically states that a "drop and swap" transaction would be allowable under Section 1031.

The most important aspect may be that IRS did not rigidly apply 1031(f)(1) when there was an exchange between related parties, and one property was disposed of.

What should a taxpayer (or his or her advisor) do in these circumstances? When the policy underlying Section 1031 is considered, it seems clear that the position adopted by the courts more clearly reflects Congress's intent than does the Service's position in the Revenue Rulings issued in the 1970s. Moreover, those Rulings were issued in a litigation context, which makes them doubly suspect. It would be beneficial to all taxpayers if the IRS were to recognize the inapplicability of those earlier Rulings and revoke them. Nevertheless, until the Service does so, most taxpayers will continue to engage in drop and swap transactions, and their advisors usually will simply inform them of the risks involved but not attempt to prevent the transactions or otherwise disclose them on returns.

Swap and Drop Transactions

The next issue is whether a "swap and drop" transaction, in which there is a post-exchange transfer of the replacement property to a partnership, jeopardizes the nonrecognition treatment of an exchange. This issue also turns on whether such transfer violates the "held for" requirement. Once again, the IRS and the courts have established opposing positions.

IRS position. In Rev. Rul. 75-292, 1975-2 CB 333, the IRS ruled that a taxpayer's transfer of replacement property to its wholly owned corporation violated the "held for" requirement.

The taxpayer transferred land and buildings used in its trade or business to W, an unrelated corporation, in exchange for land and an office building owned and used by W in its trade or business. Immediately following this exchange, the taxpayer contributed its replacement property to a newly created corporation (Y) in a transaction that qualified under Section 351.

According to the IRS, the "held for" requirement was violated because its replacement property received from W "was to be transferred to Y and was not to be held by" the taxpayer. Although Rev. Rul. 75-292 does not include an in-depth discussion of how the IRS reached this decision, this Ruling established the Service's position that a taxpayer will violate the "held for" requirement if a corporate entity is interposed between the taxpayer and its replacement property immediately following the transfer of such property.

Put another way, based on Rev. Rul. 75-292 it appears that the IRS is unwilling to accept the view that the transferor's intent of transferring property into a corporation in exchange for stock (which will usually be held for investment) should carry over, which is contrary to the conclusion subsequently reached by the IRS in Ltr. Rul. 9751012.

Position of the courts. Rev. Rul. 75-292 does not indicate whether the interposition of a partnership between a taxpayer and its replacement property would violate the "held for" requirement. Nonetheless, in *Magneson* the IRS argued that its prohibition on post-exchange transfers of replacement property to controlled corporations, as established in Rev. Rul. 75-292, should apply to partnerships as well.

The taxpayers in *Magneson* transferred their fee interest in real property and an apartment building to X solely in exchange for a 10% undivided interest in commercial property. On the same day, (1) the taxpayers exchanged cash and their replacement property for a general partnership interest in a limited partnership in a transaction that qualified for nonrecognition treatment under Section 721, and (2) the limited partnership acquired the remaining 90% undivided interest of the taxpayers' replacement property.

In the Tax Court, the IRS argued that, on the contribution of the replacement property to the partnership, the taxpayers no longer satisfied the "held for" requirement under Section 1031(a)(1) because the partnership—and not the taxpayers—held the replacement property. The court disagreed with this analysis of the "held for" requirement.

In considering whether a taxpayer satisfied the "held for" requirement following its receipt of replacement property, the Tax Court did not focus its analysis on whether the taxpayer literally continued to hold such property. Rather, the court concluded that the taxpayers "merely effected a change in the form of the ownership of their investment instead of liquidating their investment." According to the Tax Court, "for tax purposes, joint ownership of

the property and partnership ownership of the property are merely formal differences and not substantial differences." Thus, the taxpayers continued their ownership interest in the replacement property following their contribution of such property to the partnership and thereby satisfied the "held for" requirement under Section 1031(a)(1).

The Ninth Circuit affirmed, for similar reasons. The appellate court concluded that the taxpayers' contribution of the replacement property to a partnership did not violate the "held for" requirement because, at the time of the like-kind exchange, the taxpayers intended to and did continue to hold the replacement property.

The appellate court agreed with the Tax Court that a mere change in the form of a taxpayer's ownership of replacement property did not constitute a per se violation of the "held for" requirement. According to the Ninth Circuit, so long as the taxpayers continued to own the property and to hold it for investment, "a change in the mechanism of ownership which does not significantly affect the amount of control or the nature of the underlying investment does not preclude nonrecognition under section 1031(a)." As the court explained further, the contribution of replacement property to a partnership would not significantly affect the nature of this investment as long as the taxpayers' interest in the partnership's underlying assets was of like-kind to their original investment.

The Ninth Circuit also considered the alternative argument posited by the IRS that, on application of the step transaction doctrine, the taxpayers would have transferred their interest in the relinquished property for a general partnership interest. The court reasoned that, even under this scenario, the taxpayers would have satisfied the "held for" requirement because the taxpayers as "general partners are the managers of their investment, just as they were when they owned the [relinquished property] in fee simple."

As the Ninth Circuit made clear, however, its discussion of the step transaction doctrine in *Magneson* was merely dicta because "it is not readily apparent" that the transaction could have been achieved in fewer steps. Under this doctrine, a taxpayer may not secure, by a series of contrived steps, different tax treatment than if it had carried out the transaction directly.

In *Magneson,* the intent of the exchange parties was to end up as co-owners of the partnership that held the entire replacement property. Because the value of the relinquished property was 10% of the entire replacement property, the taxpayers planned to "pay" for their share of the replacement property with the relinquished property.

If the parties had not undertaken a like-kind exchange, the taxpayers also could have achieved their desired result by (1) selling the relinquished property, (2) using the proceeds to buy 10% of the replacement property, (3) contributing this interest to a partnership, and (4) having the co-owner of the replacement property contribute its 90% share of the replacement property to the same partnership. This scenario involves more steps (four) than the like-kind exchange (three).

Alternatively, the taxpayers could have (1) contributed the relinquished property to a partnership, (2) caused the other exchange party to contribute 90% of the replacement property to the same partnership, and (3) caused the partnership to exchange (prior to Section 1031(a)(2)(D), as discussed below) the relinquished property for the remaining 10% of the replacement property. This alternative involves the same number of steps (three) as in the like-kind exchange. Nonetheless, the Ninth Circuit concluded that the step transaction doctrine should not apply because between two equally direct ways of achieving the same result, the taxpayers "were free to choose the method which entailed the most tax advantages to them."

If the Ninth Circuit had accepted the Service's argument in *Magneson* that the step transaction doctrine should apply—and thereby treated the taxpayers as if they transferred their interest in the relinquished property for a general partnership interest—one could argue that the 1984 amendment to Section 1031 diminished *Magneson*'s precedential value.

As noted above, Section 1031 was amended to exclude partnership interests from qualifying as replacement or relinquished property in a like-kind exchange. As described in the Senate Report accompanying DRA '84, Congress enacted Section 1031(a)(2)(D) because it was "particularly concerned by the use of the like-kind exchange rules to facilitate the exchange of interests in tax shelter investments for interests in other partnerships." "Under this arrangement," the Report states further, "taxation of the gain inherent in an interest in a 'burned out' tax shelter partnership—i.e., a partnership which has taken substantial deductions for nonrecourse liabilities without actually paying off such liabilities, and hence without the partners suffering real economic loss—may be able to be avoided if the interest is exchanged, tax-free, for an interest in another partnership."[9]

Because neither the Ninth Circuit nor the Tax Court treated the like-kind exchange in *Magneson* as an exchange of property for a partnership interest, the subsequent introduction of Section 1031(a)(2)(D) should have no bearing on *Magneson*'s continuing vitality. Furthermore, as the legislative history of Section 1031(a)(2)(D) makes clear, the rationale of Congress in excluding partnership interests from Section 1031 is inapplicable.

In addition, as described above, in *Bolker* the Ninth Circuit affirmed the Tax Court's decision that Section 1031 does not require a taxpayer to hold relinquished property for a minimum period before such property is transferred as part of a like-kind exchange. For purposes of determining whether the post-exchange contribu-

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[9] S. Rep't No. 98-169, Vol. 1, 98th Cong., 2d Sess. 243 (1984).

tion of replacement property to a partnership violates the "held for" requirement, the Ninth Circuit's decision in *Bolker* is significant because it set forth the rule that if a taxpayer acquires property which "he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in trade or business or for investment' within the meaning of section 1031(a)."

Similarly, in *Maloney,* 93 TC 89 (1989), the Tax Court considered whether the liquidating distribution of replacement property to a corporation's controlling shareholder nearly one month following a like-kind exchange involving such property violated the "held for" requirement. As the court pointed out, pre-exchange transfers of relinquished property and post-exchange transfers of replacement property do not violate the "held for" requirement if, as established in *Magneson* and *Bolker,* the taxpayer intends to continue holding the relevant property for investment or for use in a trade or business, and the taxpayer's ownership interest in such property continues.

Under this rule, the transfer of replacement property to a corporation's controlling shareholder did not diminish the shareholder's investment intent and continuity of ownership with regard to such property because "[a]s we understand *Magneson* and *Bolker,* the mere addition of another nontaxable transaction (at least, a transaction exempted by section 721 or 333) does not automatically destroy the nontaxable status of the transaction under section 1031."

In *Marks v. Dept. of Revenue,* TC-MD 050715D (7/24/07), the Oregon Tax Court (Magistrate Division) considered an exchange transaction involving (1) the transfer (through a QI) of two apartment buildings, (2) the acquisition (through the QI) of a ranch property, and (3) the contribution (apparently shortly after the exchange was completed) of the ranch property to a partnership. The court held that the subsequent partnership contribution did not vitiate Section 1031 treatment for the exchange, relying on *Magneson* and *Maloney.* The court rejected the state's argument that *Magneson* no longer was controlling authority after the enactment in 1984 of Section 1031(a)(2)(D), precluding any exchange of interests in a partnership. Somewhat curiously, the Oregon Tax Court also suggested that Section 1031(a)(2)(D) would not preclude a direct exchange of a fee interest for a partnership interest.

It even can be argued that the IRS approved a "swap and drop" transaction in Ltr. Rul. 200812012, in which a partnership which acquired replacement property in a like-kind exchange was terminated immediately after the exchange. Under Section 708(b)(1)(B), the termination of the partnership was deemed to be a transfer of its assets to a new partnership followed by the distribution of the interests in the new partnership to the old partner, i.e., there was a deemed transfer of the replacement property to a partnership. The IRS concluded that the "held for" requirement was not violated, although the IRS based its conclusion on the involuntary nature of the transfer (due to the termination of the partnership).

Practical advice. The conclusion that can be drawn from the cases and rulings involving swap and drop transactions is the same as that can be drawn from the authorities concerning drop and swap transactions—the courts have approved these transactions even if the IRS has not. Moreover, the Service's reasoning in its old, litigation-related Rulings is questionable, whereas the courts have looked at the rationale underlying the statute and approved the exchanges.

The most significant legal issue is whether the results in the cases somehow would be altered by the enactment of Section 1031(a)(2)(D), which provides that a partnership interest does not constitute replacement property. The IRS might argue, using the step transaction doctrine, that a swap and drop transaction is, in substance, the acquisition of a partnership interest as replacement property, which is impermissible under Section 1031(a)(2)(D). Specifically, the IRS could argue that the seller of the replacement property should be deemed to have transferred that property to a partnership and then have transferred the partnership interest to the taxpayer.

Although there are no authorities squarely on point, the better view is that the exchange should be tested for what occurred—real property was exchanged for real property—and the subsequent "drop" of the replacement property into another entity should be separately tested for taxability. The courts have rejected the application of the step transaction doctrine in analyzing like-kind exchanges where the taxpayer's method was as direct as any alternatives. This approach is more consistent with the Service's rulings concerning reorganizations, in which the IRS distinguishes between post-reorganization transfers and the taxability of the reorganization itself.[10]

The biggest issue that confronts tax advisors is the level of comfort that should be given to clients who engage in swap and drop transactions. Because there is no clear guidance on point, appropriate cautions should be voiced. Nevertheless, the weight of the law (and congressional intent) appears to support such transactions, so that most practitioners will simply provide warnings but will neither try to prevent such transactions nor disclose them on tax returns.

EXCHANGES OF INTANGIBLES AND BUSINESSES

Recent guidance from the Service involving exchanges of business intangibles is controversial. Many taxpayers have questioned how Section 1031 applies in situations in which entire businesses were exchanged, including particularly businesses that own intangible assets such as patents, trademarks and trade-

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10 Rev. Rul. 2001-24, 2001-1 CB 1290, and Rev. Rul. 2002-83, 2002-2 CB 927.

names, and goodwill. This question was addressed in TAM 200602034.

In that ruling, the taxpayer transferred the tangible and intangible assets pertaining to the business of two of its subsidiaries to buyers. One of the subsidiaries (Sub 1) researched, designed, manufactured, and marketed products for customers in the U.S. and around the world. The assets transferred were divided into five categories: (1) patents, (2) trademarks and tradenames, (3) designs and drawings, (4) software, and (5) trade secrets and know-how. The other subsidiary (Sub 2) designed, manufactured, marketed, tested, and repaired other property used in certain types of industrial operations in various states. These assets were divided into the same five broad categories as those of Sub 1.

The transaction was structured by the taxpayer as a like-kind exchange. In the first portion of the exchange, the taxpayer acquired the assets of Seller 1, which was engaged in the research, design, manufacture, and marketing of certain products in the U.S. These assets were divided into four broad categories: (1) trademarks and tradenames, (2) designs and drawings, (3) software, and (4) trade secrets and know-how. The taxpayer acquired from a separate seller (Seller 2) assets used in other countries and the U.S.; these assets were in the same broad categories as those acquired from Seller 1, excluding trademarks and tradenames but including patents.

The IRS first discussed its position concerning like-kind exchanges of intangibles. The Service categorically rejected the notion that a taxpayer could treat the multiple assets of a business as a single property for like-kind exchange purposes. Rather, the determination of whether (or the extent to which) an exchange qualifies under Section 1031 requires an analysis of the underlying assets involved.[11] Even seemingly small differences, such as those between numismatic gold coins and those treated as gold bullion, could make a difference in determining whether Section 1031 applies.[12] The IRS acknowledged that it has been stricter in determining what constitutes like-kind property for exchanges of personal property than for real property exchanges.

In exchanges of intangible property, the Service has adopted an even more rigorous test. According to the IRS, an exchange of intangible property requires a matching of both (1) the nature or character of the rights involved, and (2) the nature or character of the underlying property to which the intangible personal property relates. Intangible property is not of like-kind unless both of these tests are satisfied.

The taxpayer contended, instead, that for purposes of considering exchanges of patents, the four broad classes of underlying property used under U.S. patent law (process, machines, manufacture, and composition of matter) should be used to determine whether patents are of like-kind. The Service rejected this argument, however, concluding that in determining which patents are of like-kind, assuming that all patents involved in an exchange are either used predominantly in the U.S. (domestic patents) or outside the U.S. (foreign patents), the underlying property must be either of the same General Asset Class or the same Product Class or otherwise of like-kind. Only one of the patents involved in the taxpayer's exchange satisfied this rigorous test.

The taxpayer also contended that trademarks and tradenames should be treated as like-kind property. The IRS viewed trademarks and tradenames as only a part of the going-concern value of a business, which is not eligible for a like-kind exchange under Reg. 1.1031(a)-2(c)(2). The Service acknowledged that unregistered intellectual property such as designs and drawings, trade secrets and know-how, and software might theoretically qualify for like-kind treatment, but again insisted that the underlying property had to be the same; only a very limited number of the intangibles acquired by the taxpayer met this test. The IRS also concluded that foreign intangibles could not be exchanged for domestic ones, basing the determination of whether an intangible is foreign or domestic on where the underlying property is used.

The net effect of the rigorous rules established by the Service in TAM 200602034 is that it will be very difficult to satisfy the like-kind exchange rules in the case of exchanges of intangible property, except in the narrow situation in which the exchangers are engaged in the same line of business and, moreover, where the nature of the underlying assets of the two companies is similar.

In FAA 20074401F, the IRS analyzed an exchange of newspaper businesses through a QI. The memorandum concludes that the mastheads, advertiser accounts, and subscriber accounts of each newspaper are not like-kind property because "they are so closely related (if not a part of) goodwill and going concern value." Consistent with prior private rulings, the memorandum reiterates the Service's expansive view of Reg. 1.1031(a)-2(c)(2) (goodwill or going-concern value of exchanged business can never be like-kind property). The memorandum dismisses the taxpayer's reliance on *Newark Morning Ledger Co.*, 507 U.S. 546, 71 AFTR2d 93-1380 (1993) (which rejected the IRS argument that a newspaper's subscriber list fell "within the core concept of goodwill") on the ground that *Newark Morning Ledger* was a Section 167 depreciation case and not a Section 1031 case. The Service's reasoning does not appear to be justifiable.[13]

IDENTIFICATION

An exchange of intangible assets was not the only issue in TAM 200602034. In addition, the Service also addressed compliance with the

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[11] Rev. Rul. 89-121, 1989-2 CB 203, and Rev. Rul. 55-79, 1955-1 CB 370.

[12] Rev. Rul. 79-143, 1979-1 CB 264, and Rev. Rul. 76-214, 1976-1 CB 218.

[13] See McBurney, "Goodwill in Like-Kind Exchanges of Newspapers—IRS Is Inconsistent With Other Areas," 108 JTAX 147 (March 2008).

identification requirements in Reg. 1.1031(k)-1. As noted above, a taxpayer may identify within 45 days of the disposition of the relinquished property either (1) any three properties or (2) any number of properties with an FMV that does not exceed 200% of the FMV of the relinquished property. Alternatively, a taxpayer may identify any number of properties, provided that the taxpayer acquires at least 95% of the aggregate FMV of all identified properties. In addition, any replacement property acquired before the end of the 45-day identification period is automatically treated as properly identified (the "actual purchase rule").

In TAM 200602034, the taxpayer was acquiring numerous properties as replacement properties in its like-kind exchange, so that the three-property rule could not apply. Accordingly, it was necessary for the taxpayer to satisfy either the 200% rule or the 95% rule. In fact, the taxpayer acquired property having a value well in excess of 200% of the value of its relinquished property, and the taxpayer acquired intangible assets with a value less than 95% of the value of the intangible assets that were transferred. Accordingly, the only assets acquired by the taxpayer that satisfied the identification requirement were those that met the actual purchase rule, i.e., the assets acquired within 45 days of the date of sale of the relinquished property. This limitation was then coupled with the limitation concerning the nature of the underlying intangible assets to determine which assets satisfied the like-kind exchange requirement.

The IRS went further, however. It also noted that the identifications made by the taxpayer only included (1) the name of the seller, (2) a very general description of the property, i.e., intellectual property, including but not limited to patents, trademarks, copyrights, software, know-how, designs, and other intellectual property assets as may be owned, licensed, or leased by the seller, and (3) the estimated value of the assets. There was no description of the underlying property pertaining to each of these intangible assets. According to the Service, this identification was insufficient, so there was no property identified during the identification period. Thus, there was not a valid exchange due to failure to satisfy the identification requirement.

In CCA 200836024 (discussed briefly above in connection with the identification requirement), the IRS concluded that a taxpayer, in effect, may stack the 180-day-exchange period under Section 1031(a)(3) for forward exchanges and the 180-day "parking period" under Rev. Proc. 2000-37 for reverse exchanges. The transaction at issue involved a taxpayer who parked a replacement property with an EAT on date 1 and then timely identified his relinquished property for his QEAA. On the sale of his relinquished property (180 days after date 1), the taxpayer identified the parked property and three additional properties as potential replacement properties for his exchange (presumably in compliance with the 200% rule).

CCA 200836024 concluded that the taxpayer was entitled to an additional 180-day period to complete the acquisition of the other replacement properties he identified. The ruling confirms that the identification and timing requirements under Rev. Proc. 2000-37 are separate and apart from the identification and timing requirements for deferred exchanges under Section 1031(a)(3). While the ruling characterizes the overall transaction as "two separate exchanges," it is perhaps more accurate to characterize the overall transaction as a single exchange (through a QI) of one relinquished property for multiple replacement properties, one of which was parked with an EAT pursuant to a QEAA.

TENANCY-IN-COMMON TRANSACTIONS

The difficulty faced by most taxpayers in identifying replacement property was addressed in Rev. Proc. 2002-22, which set forth the guidelines under which the IRS would issue a ruling that a TIC interest in property would not be treated as a partnership interest under Section 1031(a)(2)(D).

There was a well-established body of law in this area, but the Service's position was not clear. At the heart of the legal analysis are several cases, including the Supreme Court's decision in *Culbertson,* 337 U.S. 733, 37 AFTR 1391 (1949). There, the Court stated that whether a partnership is created depends on whether the alleged partners really and truly intended to join together for the purpose of carrying on business and sharing the profits or losses or both. This determination is a question of fact, to be determined by the partners' testimony, their agreement, and their conduct. Subsequent decisions, such as *Luna,* 42 TC 1067 (1964), set forth specific factors to be considered in determining whether an arrangement should be treated as a partnership for tax purposes.[14]

Prior to 2000, the IRS had considered the treatment of TIC interests in Rev. Rul. 75-374, 1975-2 CB 261, which concluded that a two-person co-ownership of an apartment building rented to tenants was not a federal tax partnership. In that Ruling, the co-owners employed an agent to manage the apartments on their behalf. The agent collected rents; paid property taxes, insurance premiums, and repair and maintenance expenses; and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The Ruling concluded that the agent's activities were not sufficiently extensive to cause the co-ownership to be characterized as a partnership for federal income tax purposes.

In contrast to Rev. Rul. 75-374 were several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in *Bergford,* 12 F.3d 166, 73 AFTR2d 94-498 (CA-9, 1993), 78 investors purchased "co-ownership" interests in computer

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[14] For more on these and related issues, see Carman and Kushner, "The Uncertain Certainty of Being a Partner: Partner Classification for Tax Purposes," 109 JTAX 165 (September 2008).

equipment that was subject to a seven-year net lease. The investors authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow.

The agreement allowed the investors to decide by majority vote whether to sell or lease the equipment at the end of the initial lease term; absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10% of the equipment's selling price or lease rental whether or not an investor terminated the agreement or the manager performed any remarketing. An investor could assign her interest in the property only after fulfilling numerous conditions and obtaining the manager's consent.

The *Bergford* court held that the co-ownership arrangement was a partnership for tax purposes. In reaching this conclusion, the Ninth Circuit emphasized the limitations on each investor's ability to sell, lease, or encumber either her interest or the underlying property, as well as the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Two other courts reached similar conclusions where a promoter/manager maintained a significant economic interest in the property that was sold to co-owning investors.[15]

In another important decision, *Madison Gas & Electric Company*, 633 F.2d 512, 46 AFTR2d 80-5955 (CA-7, 1980), *aff'g* 72 TC 521 (1979), the court held that a co-generation operation conducted by three utilities as tenants in common was a partnership for tax purposes because the parties shared expenses and divided the jointly produced property among themselves.

In Rev. Proc. 2002-22, the IRS set forth new ruling guidelines for purposes of determining whether an arrangement involving rental real estate that was treated as a TIC for local law purposes would be treated as the ownership of real estate or a partnership for tax purposes. The Procedure states that these guidelines are to be used solely in assisting taxpayers in preparing ruling requests, and the IRS in issuing rulings, and that they are not intended to be substantive rules or used for audit purposes. The Service ordinarily will not consider a request for a ruling if the conditions provided in Rev. Proc. 2002-22 are not satisfied, although even if all such conditions are met the IRS still may decline to issue a ruling whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

A detailed discussion of all of the requirements in Rev. Proc. 2002-22 is beyond the scope of this article.[16] Practitioners, however, are rapidly becoming comfortable with the idea that several of the requirements in Rev. Proc. 2002-22 are "essential elements" of a TIC arrangement, whereas some other requirements are not as critical or can be modified to a certain degree. The practical result of these conclusions is that real estate companies are obtaining favorable opinions from counsel for TIC transactions that satisfy the most essential elements of Rev. Proc. 2002-22 but that may contain variations on minor points.

How to hold title. The first of the conditions for obtaining a ruling under Rev. Proc. 2002-22 is set forth in section 6.01, which provides that "[e]ach of the co-owners must hold title to the [p]roperty (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the [p]roperty as a whole may not be held by an entity recognized under local law." This seemingly innocuous statement has two key components.

By rejecting any ruling requests if title to the property is held by an entity, the IRS is stating that it will not view favorably attempts by taxpayers to elect out of partnership status under Section 761. That is, even if all of the requirements of Reg. 1.761-2(a)(2) are satisfied, the mere ownership of title by a legal entity is sufficient to bar a ruling that a partnership is not present.

Nevertheless, Rev. Proc. 2002-22 specifically endorses the use of disregarded entities to hold title to the TIC interests. This provision is critical because, as a practical matter, each of the co-owners frequently will be required by the other co-owners (or the sponsor) to place his or her TIC interest into a disregarded entity (usually an SMLLC) in order to avoid legal risks arising from the death or bankruptcy of a co-owner. If a TIC interest is held by an SMLLC, the death or bankruptcy of the owner of the SMLLC will not directly affect the other owners of interests in the property. In contrast, if the TIC interests were owned directly, each of the co-owners could find its economic position subject to judicial control as a result of the death or bankruptcy of a co-owner of the property. Thus, section 6.01 provides an important endorsement for the holding of TIC interests through SMLLCs, which is an essential aspect of any well-constructed ownership structure.

Avoid the appearance of a partnership. Another important requirement is that the owners of the real property not hold themselves out as engaged in a joint venture or partnership. According to section 6.03 of the Procedure, the co-ownership may not do any of the following:

- File a partnership or corporate tax return.
- Conduct business under a common name.
- Execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity.
- Otherwise hold itself out as a partnership or other form of business entity.

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15 Bussing, 88 TC 449 (1987), *reconsideration den.*; Alhouse, TCM 1991-652.

16 See Lipton, "New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges," 96 JTAX 303 (May 2002).

Similarly, the co-owners may not hold themselves out as partners, shareholders, or members of a business entity. In addition, the co-owners generally cannot have held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.

Approval rights. The owners of the TIC interests also must retain approval rights over the most important issues affecting their property. According to section 6.05 of the Procedure, the co-owners must retain the right to approve the following:

- The hiring of any manager.
- The sale or other disposition of the property.
- Any leases of a portion or all of the property.
- The creation or modification of a blanket lien.

Any sale, lease, or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners.

For all other actions, the co-owners may agree to be bound by the vote of those holding more than 50% of the undivided interests in the property. A co-owner who has consented to an action may provide the property manager or some other person a power of attorney to execute specific documents with respect to that action, but not a global power of attorney.

Although these requirements for TIC approval seem somewhat onerous, a practical approach has been sanctioned by the IRS. Specifically, most TIC agreements now contain an "implied consent" provision under which each of the co-owners is provided notice of an event (a sale, lease, financing, or reappointment of the property manager), and each co-owner is then given a specified period of time to object (usually 72 hours for a lease, and much longer for a sale, financing, or reappointment of the property manager). If none of the co-owners objects to the proposed action, it is deemed to have been approved. This type of "implied consent" was approved by the IRS in Ltr. Rul. 200327003, although it is not clear if this ruling applies outside of reappointment of the manager.

A related result of these approval requirements is that TIC arrangements currently take one of two forms.

1. Some TIC arrangements involve a long-term triple-net master lease of the property to a tenant (often related to the sponsor or promoter of the arrangement); the master lessee subleases the property to the tenants who are its actual users. This type of arrangement obviates the need for the co-owners to approve leases for the property, because the co-owners have approved the master lease but are not required to approve each sublease for the property. Because the rent paid to the co-owners must be either a flat rent or based on gross receipts, the master lessee can make a significant profit from the spread between the rent paid to the co-owners and the rent received from the actual tenants in the property. (If the property is not performing optimally, however, the co-owners can expect to receive fixed rent from the master lessee, who will bear any loss resulting from insufficient rent from the sub-lessees.)

2. To minimize this potential "leakage" for the benefit of the master lessee, other TIC sponsors prefer to structure transactions in which rent is paid by the tenants to the co-owners, and a property manager is hired to operate the property. The advantage of this structure is the absence of a master lease; the disadvantage is that co-owner consents must be obtained for each new lease and the property management agreement must be renewed at least annually.

Thus, there is a trade-off between simplicity and potential economic returns, and respectable sponsors have structured transactions both ways. The difficulty of obtaining approval of each lease also can be mitigated by the use of leasing guidelines, under which the co-owners annually approve the form of lease and rental guidelines, with the property manager being permitted to enter into a lease that conforms to both without seeking approval from the co-owners.

Restrictions on alienation. Another important aspect of each TIC arrangement involves restrictions on alienation. In general, each co-owner must have the right to transfer, partition, and encumber the co-owner's TIC interest in the property without the agreement or approval of any person. Nevertheless, restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited.

Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (i.e., the right to have the first opportunity to offer to purchase the TIC interest). In addition, a co-owner may agree to offer its TIC interest for sale to the other co-owners, the sponsor, or the lessee at FMV before exercising any right of partition, with the FMV to be determined as of the time the partition right is exercised.

Distributions and sharing. Under section 6.07 of Rev. Proc. 2002-22, if the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. This provision prevents the retention of profit or debt by one of the co-owners on the sale of the property, which would be indicative of a partnership (through the non-pro-rata sharing of profits and liabilities).

Each co-owner also must share in all revenue generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property, under section 6.08. In addition, "[n]either the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disre-

garded entity, the owner of the co-owner) and is not for a period exceeding 31 days."

The requirement that all profits and costs related to the property be shared pro rata is not surprising; non-pro-rata sharing of the costs or benefits of operation of the property would be evidence of a partnership arrangement. More unusual, however, is the requirement that one co-owner cannot advance funds for the benefit of another for any period in excess of 31 days. Thus, for example, if there is an operating cash-flow shortfall, one co-owner can cover the shortfall for only a limited period. On the expiration of this 31-day period, either all co-owners would have to contribute their pro rata share of the cash needs of the property or, in the alternative, the property (or the TIC interests of the defaulting co-owners) presumably would have to be sold.

The parenthetical clause in section 6.08 of Rev. Proc. 2002-22, quoted above, has become one of the most ignored aspects of this guidance. This provision would mandate that the individuals who own the interests in the SMLLC that actually holds the TIC interest would be personally liable to contribute cash to the SMLLC in the event that any other co-owner made an advance to cover operating deficits. As a practical matter, the effect of this provision would be to convert potentially nonrecourse liabilities into recourse obligations.

Moreover, most lenders require that the SMLLC be a "bankruptcy remote" entity, so that the SMLLC is not obligated for the debts of its owner, and vice versa. The individual liability imposed by this parenthetical in section 6.08 would be contrary to the covenants required in most loan documents, so that a choice would need to be made between compliance with Rev. Proc. 2002-22 or compliance with the loan covenants.

It also is difficult to understand why the IRS feels that personal liability for such obligations provides less indicia of a partnership. While it was true under the old *Kintner* Regulations that unlimited liability was a partnership factor, the advent of the LLC and the check-the-box Regulations indicate that unlimited liability may be more of a historic factor. The better view is that such a restriction in today's environment is not needed and is inconsistent with business (i.e., non-tax) motives. Almost all TIC transactions comply with lender requirements, so that this parenthetical is ignored in most transactions in which there is debt financing, particularly if the debt is securitized.

Leverage and nonrecourse carveouts. The most significant issue in structuring TIC transactions often will concern the requirements imposed by the lender. As noted above, most lenders require the investors to own their TIC interests through SMLLCs, and the lenders will further require that the borrowers waive their right to partition or transfer the property without consent from the lender, and the requirement for substantive nonconsolidation will lead to noncompliance with the parenthetical in section 6.08 of the Procedure. These requirements are all readily satisfied in most TIC transactions.

Nevertheless, most real property loans are nonrecourse obligations, meaning that the lender can look only to the underlying assets (and not to the borrowers) to recover in the event that the value of the property drops. Most lenders will require that the nonrecourse nature of the loan be disregarded in the event that certain events occur ("nonrecourse carveouts"). These carveouts will frequently include:

- Fraud, intentional misrepresentation, or willful misconduct.
- The borrower's amendment, termination, cancellation, modification, or replacement of the TIC agreement without the lender's consent.
- The borrower's filing of a partition action or a lien or other encumbrance against the property.
- The failure to obtain the lender's approval of any subordinate financing or voluntary lien encumbering the property.
- The failure to obtain the lender's approval of any assignment, transfer, or conveyance of the property or any interest in the property.
- The failure to comply with the provisions of the mortgage loan documents with respect to the leasing of the property.
- A transfer of control of the borrower or its SMLLC not in compliance with the requirements of the mortgage loan documents.
- The SMLLC ceases to be a single-purpose entity.
- The SMLLC files a voluntary petition under the U.S. bankruptcy code or any other state or federal bankruptcy or insolvency law.
- The borrower, its SMLLC, or their affiliates file or acquiesce in the filing of any involuntary petition under the U.S. bankruptcy code or any other state or federal bankruptcy or insolvency law.

The types of remedies that are available to the lender on the occurrence of one of these specified events often will vary. On the occurrence of any of the first three provisions set forth above, the loan documents often will provide that the borrower is liable for any losses incurred by the lender as a result of the event. In contrast, if any of the last seven events occur, the loan documents frequently will provide that the entire loan will become a recourse liability of the offending borrower. This is usually referred to as a "springing recourse" loan, meaning that it becomes a recourse loan only if certain unanticipated events occur.

The first question is whether these nonrecourse carveouts are inconsistent with the basic requirement that all obligations are shared pro rata among the TIC investors. The general view of most practitioners is that nonrecourse carveouts should be disregarded for this purpose because these events are not ever supposed to occur. Otherwise, every loan could be treated as a recourse obligation, even though the likelihood of recourse is so remote as to be negligible.

A more frequent question will involve whether the person who

arranged the TIC offering (the sponsor) also can be obligated in the event one of the investors violates one of the nonrecourse carveouts. A lender who is providing a loan to TIC investors usually knows the sponsor but not the investors, and the lender frequently will be relying on the sponsor to sell interests only to "good" investors who do not violate the loan requirements. Moreover, the sponsor or its affiliate often will serve as the master lessee or property manager, giving the sponsor effective control over the property. If one of the investors turns out to be "bad," the lender likely would want or expect the sponsor to pay for any damages incurred by the lender.

This natural instinct of the lenders has to be overcome, however. Indeed, it is now standard in TIC transactions for each investor to be responsible only for its own actions, and for the sponsor to be responsible solely for its actions and those of its affiliates. Thus, the lender's request that the sponsor be liable for the actions of TIC investors usually will be declined. The only exception to this general rule could involve situations in which the sponsor has failed to perform on its own obligations, e.g., if the sponsor is the property manager, insurance proceeds should never find their way into the hands of the investors, so that a misappropriation by an investor is really the sponsor's fault.

Other elements. Several other aspects of Rev. Proc. 2002-22 have been reflected in most transactions. First, section 6.09 provides that the co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests; this requirement is generally viewed as essential. Likewise, the co-owners cannot have the right to put their interests to any other person, including the sponsor, the lessee or any other co-owner. A co-owner may grant a call option to any other person, however, provided that the purchase price under the call option reflects the FMV of the property.

This latter rule has become an important practical element of most TIC arrangements. As noted previously, unanimous consent is required for most important actions involving the property, including sale, leasing, financing, and appointment of the property manager. In order to avoid the possibility that one co-owner can prevent the other co-owners from undertaking necessary or appropriate actions, each of the co-owners usually is required to grant a call option and a limited power of attorney that provides that if a specified percentage of the co-owners agree to an action, the dissenting co-owners will have to sell their interests to the consenting co-owners for FMV.

Summary. Rev. Proc. 2002-22 provides a set of rules that are practical in most situations and that most sponsors and co-owners are able to comply substantially with. The effect of this guidance has been to "regularize" an industry that, prior to the issuance of the guidance, operated without any rules. The praise IRS received when it issued Rev. Proc. 2002-22 can be expected to continue if the Service demonstrates flexibility in rulings on the open issues discussed above.

DELAWARE STATUTORY TRUSTS

The most recent guidance concerning multiple ownership of replacement properties involved DSTs. Based on Rev. Proc. 2002-22, it seemed doubtful that the IRS would allow taxpayers to own replacement property through a legal entity such as a DST. The Service surprised everyone, however, by issuing Rev. Rul. 2004-86, 2004-2 CB 191, which addressed the tax treatment of trusts in very limited situations.[17]

The trust and the lease. In the Ruling, an individual (John) borrowed money from an unrelated bank and signed a ten-year, interest-bearing, nonrecourse note. John used the loan proceeds to purchase rental real property (Blackacre), which was the sole collateral for the loan from the bank.

Immediately thereafter, John net-leased the property to Mary for ten years.[18] Under the terms of the lease, Mary was required to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, she was required to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Mary was free to sublease Blackacre to anyone she chose.

The rent paid by Mary to John was a fixed amount that could be adjusted by a formula described in the lease agreement that was based on a fixed rate or an objective index, such as an escalator clause based on the Consumer Price Index, but adjustments to the rate or index were not within the control of any of the parties to the lease. The rent paid by Mary was not contingent on her ability to lease the property or on her gross sales or net profits derived from Blackacre.[19]

On the same date that John acquired Blackacre and leased it to Mary, John also formed a DST ("the trust") to which he contributed fee title to Blackacre after entering into the loan with the bank and the lease with Mary. The trust assumed John's rights and obligations under the loan from the bank as well as under the lease with Mary. In accordance with the nonrecourse nature of the note, neither the trust nor any of its beneficial owners were personally liable to the bank for the loan, which continued to be secured by Blackacre.

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[17] See Lipton, Golub, and Cullen, "Delaware Statutory Trusts and 1031: A Marriage Made in Heaven or Just a Pipe Dream?," 101 JTAX 140 (September 2004).

[18] The Ruling did not indicate whether John was related to Mary, but given that the IRS stated that Mary was not related to persons described in the Ruling other than John, it can be assumed that she may be related to him.

[19] Although the lease from John to Mary is described in the Ruling as a "net" lease, it is not clear whether the lessor or the lessee would be required to make capital improvements or major repairs to the property. Thus, the lease might be "double net," in which the lessor remains liable for certain capital improvements and repairs (such as repairs to the roof), instead of a "triple net" lease in which the lessee is responsible for the property in all events.

The trust agreement provided that interests in the trust were freely transferable, although the interests were not publicly traded on an established securities market. The trust was to terminate on the earlier of ten years from the date of its creation or the disposition of Blackacre, but would not terminate on the bankruptcy, death, or incapacity of any owner, or the transfer of any right, title, or interest of the beneficial owners, of the trust. The agreement further provided that interests in the trust would be of a single class, representing undivided beneficial interests in the assets of the trust (i.e., Blackacre).

Rev. Rul. 2004-86 does not indicate whether the trustee was an individual or an institution, although it expressly states that the trustee was not related to the bank or the lessee of the property. Under the trust agreement, the trustee was authorized to establish a reasonable reserve for expenses incurred in connection with holding Blackacre that might be payable out of the trust's funds.

All available cash less reserves had to be distributed quarterly to each beneficial owner in proportion to their respective interests in the trust. In addition to the right to a quarterly distribution of cash, each beneficial owner had the right to an in-kind distribution of its proportionate share of the property of the trust.

The trustee was required to invest cash received from Blackacre between each quarterly distribution. All cash held in reserve had to be invested in short-term obligations of (or guaranteed by) the U.S., or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee was permitted to invest only in obligations maturing prior to the next distribution date, and was required to hold such obligations until maturity.

The agreement provided that the trustee's activities were limited to the collection and distribution of income. The trustee could not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) for the trust from the beneficiaries. The trustee also could not renegotiate either the terms of the debt used to acquire Blackacre or the lease with Mary, or enter into leases with tenants other than Mary except in the case of Mary's bankruptcy or insolvency.

In addition, the trustee was permitted to make only minor, nonstructural modifications to Blackacre, unless otherwise required by law. The agreement further provided that the trustee could engage in ministerial activities to the extent required to maintain and operate the trust under local law. Finally, the trustee did not enter into a written agreement with John, or indicate to third parties, that the trustee (or the trust) was his agent.

Immediately after John formed the trust, he conveyed his entire interest in the trust to Dick and Jane in exchange for interests in Whiteacre and Greenacre, respectively. Dick and Jane were not related to the lending bank or to Mary (the lessee of Blackacre), and neither the trustee nor the trust was an agent of Dick or Jane. John did not claim that his exchange qualified as a like-kind exchange under Section 1031 (which would be difficult for him to do because he did not acquire Blackacre for investment or for use in a trade or business). Dick and Jane, however, wanted to treat the interests in the trust that they acquired as replacement property in a like-kind exchange for their relinquished properties, Whiteacre and Greenacre, respectively.

Classification. The fundamental concept that underlies Rev. Rul. 2004-86 is that a DST is an entity for federal income tax purposes that is recognized as separate from its owners. Creditors of the beneficial owners of the DST could not assert claims directly against the property held by the DST. A DST may sue or be sued, and the property of a DST is subject to attachment and execution as if it were a corporation. The beneficial owners of a DST are entitled to the same limitation on personal liability stemming from actions of a DST that is extended to shareholders of a Delaware corporation. A DST may merge or consolidate with or into one or more statutory entities or other entities, such as a partnership, and a DST can be formed for investment purposes.

Based on the purpose of, and the powers and privileges afforded to, a DST and the beneficial owners thereof, the IRS concluded in Rev. Rul. 2004-86 that the trust was an entity that could not be disregarded for federal income tax purposes. Thus, it was necessary to classify the trust for tax purposes as either a business entity or a trust.

The first question addressed in the Ruling, which if decided in the affirmative might have obviated further discussion, was whether the trust should be viewed as an agent of John or its subsequent beneficial owners (Dick and Jane). The IRS noted that it was assumed that neither the trust nor the trustee was an agent of John, Dick, or Jane, and that neither the trust nor the trustee held themselves out as their agent to third parties. Furthermore, the beneficiaries of the trust did not enter into an agency agreement with either the trust or the trustee. Thus, pursuant to the Supreme Court's decision in *Bollinger,* 485 U.S. 340, 61 AFTR2d 88-793 (1988), neither the trust nor the trustee could be viewed as an agent of the beneficial owners of the trust.

The Service then concluded that this situation also had to be distinguished from Rev. Rul. 92-105, 1992-2 CB 204. In that Ruling, an Illinois land trust was effectively disregarded in determining whether its beneficiary could transfer an interest therein as part of a Section 1031 exchange. The IRS noted that the beneficiary in Rev. Rul. 92-105 retained the direct obligation to pay liabilities and taxes relating to the property, whereas in Rev. Rul. 2004-86 the trust assumed John's obligations under the loan from the bank and the lease with Mary.

Furthermore, the DST provided

the beneficial owners of the trust with the same limitation on personal liability extended to shareholders of a Delaware corporation, whereas there was no limitation on the liability of the beneficiary of the Illinois land trust. Moreover, the beneficiary of the Illinois land trust retained the right to manage and control the property of the trust, whereas in Rev. Rul. 2004-86 the beneficiaries had no right to control or manage the trust's property. Thus, the Illinois land trust was disregarded because it could not rise to the level of an "entity," whereas the trust in Rev. Rul. 2004-86 had to be classified as an entity because it had sufficient powers to constitute a separate entity for tax purposes.

Having concluded that the trust was not the agent of its beneficiaries, and that it could not be disregarded in the manner that the Illinois land trust in Rev. Rul. 92-105 was disregarded, the IRS turned to the classification of the trust for tax purposes.

Because a DST is an entity separate from its owner, the DST must either be a trust or a business entity for federal tax purposes. To determine whether the trust in Rev. Rul. 2004-86 was taxable as a trust or a business entity, it was necessary to determine whether there was a power under the trust agreement to vary the investment of the holders of the beneficial interests in the trust.

In Rev. Rul. 2004-86, on the date of (but immediately prior to) the transfer of Blackacre to the trust, John also (1) entered into a ten-year nonrecourse loan with the bank secured by Blackacre and (2) leased Blackacre to Mary for ten years. All of John's rights and obligations under the loan and the lease were assumed by the trust. Because the duration of the trust was the same as the duration of the loan and the lease that were assumed by the trust at the time of its formation, the financing and leasing arrangements related to the trust and its assets (Blackacre) were fixed for the entire life of the trust.

Moreover, the trustee was permitted to invest only in short-term obligations that matured prior to the next distribution date, and was required to hold these obligations until maturity. Because the trust agreement provided that (1) any cash from Blackacre, and any cash earned on short-term obligations held by the trust between distribution dates, had to be distributed quarterly, (2) no cash could be contributed to the trust by the beneficiaries, (3) the trust could not borrow money, and (4) the disposition of Blackacre would result in the termination of the trust, there was no possibility of the reinvestment of money under the agreement.

In analyzing the tax classification of the trust, the IRS emphasized that the trustee's activities were limited to the collection and distribution of income. The trustee could not exchange Blackacre for other property, purchase assets other than short-term investments or accept any additional contributions of assets (including money) for the trust. The trustee could not renegotiate the terms of the debt used to acquire Blackacre and could not renegotiate the lease with Mary or enter into leases with tenants other than Mary except in the event of her bankruptcy or insolvency. In addition, the trustee could make only minor non-structural modifications to its property except to the extent required by law.

The limited power of the trustee was, in the Service's view, the key to distinguishing this situation from Rev. Rul. 78-371, 1978-2 CB 344. In that Ruling, a trust was classified as a business entity because the trustee had powers unrelated to the conservation of the trust's assets. In Rev. Rul. 2004-86, however, the trustee had none of the powers that would indicate an intent to carry on a profit-making business. Because all of the interests in the trust were of a single class representing undivided beneficial interests in the assets of the trust, and because the trustee had no power to vary the investment of the beneficiaries of the trust so as to benefit from fluctuations in the market, the trust was classified as a trust under Reg. 301.7701-4(c)(1).

Using trust interests in a like-kind exchange. The next question considered in Rev. Rul. 2004-86 was whether the purchase of interests in the trust by Dick and Jane would be treated as an acquisition of interests in the real property (Blackacre) owned by the trust (in exchange for their interests in Whiteacre and Greenacre that were conveyed to John). The IRS indicated that this analysis was to be made under the grantor trust provisions.

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust, the taxable income and credits of the grantor or the other person will include those items of income, deduction, and credit of the trust that are attributable to that portion of the trust to the extent that the items would be taken into account in computing taxable income or credits against the tax of an individual.

Under Reg. 1.671-2(e)(1), a grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust. Reg. 1.671-2(e)(3) provides that "grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in an investment trust. Under Section 677(a), the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is (or, in the discretion of the grantor or a non-adverse party, or both, may be) distributed or held or accumulated for future distribution to the grantor or the grantor's spouse. A person that is treated as the owner of an undivided fractional interest of a trust (under Section 671) is considered, for federal income tax purposes, to own the trust assets attributable to that undivided fractional interest.

In Rev. Rul. 2004-86, IRS determined that Dick and Jane should be treated as grantors of the trust under Reg. 1.671-2(e)(3) when they acquired their interests in the trust from John, who had formed the trust. Because Dick and Jane had the right to distributions of all the income of the trust attributable to

their undivided fractional interests, they were treated under Section 677 as the owners of an aliquot portion of the trust, and all income, deductions, and credits attributable to that portion would be includable by Dick and Jane in computing their taxable incomes. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, Dick and Jane were thus each considered to own an undivided fractional interest in Blackacre for federal income tax purposes.

Based on this reasoning, the IRS then concluded that the exchange of real property (Whiteacre and Greenacre) by Dick and Jane for an interest in the trust was the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust or beneficial interest under Section 1031(a)(2)(E). Because the properties exchanged were of like-kind, and assuming that the other requirements of Section 1031 were met by Dick and Jane (e.g., they held Whiteacre and Greenacre for investment or for use in a trade or business, and they timely identified and acquired interests in the trust as replacement property), the exchange of real property for an interest in the trust qualified for nonrecognition of gain or loss under Section 1031. Moreover, because the trust was a grantor trust under Section 671, the outcome to the parties would have been the same even if John had transferred interests in Blackacre to Dick and Jane, who then immediately contributed their interests in Blackacre to the trust.

Impact. The grantor trust aspect of Rev. Rul. 2004-86 is quite helpful to taxpayers. For years, many practitioners had been hesitant, for purposes of completing a Section 1031 exchange, to treat an interest in a grantor trust the same as an interest in the property owned by the trust. The limited guidance concerning what constituted a "certificate of trust or beneficial interest" under Section 1031(a)(2)(E) led to fear that the IRS could assert that an interest in a grantor trust was not the same as an interest in the underlying assets of the trust.

Moreover, Section 671 does not explicitly state that the taxpayer holds property held by a grantor trust—it just treats the grantor as the owner of assets of the trust for purposes of computing the grantor's taxable income. Accordingly, some practitioners were concerned that the acquisition of an interest in a grantor trust might not satisfy the "held for" requirement in Section 1031(a)(1).

Rev. Rul. 2004-86 put these fears to rest by expressly stating that the interest of a grantor in a grantor trust will be treated the same as the ownership of the underlying property held by the trust. As a result, taxpayers can acquire property by obtaining an interest in a grantor trust or, in the alternative, they may transfer property to a grantor trust immediately after its acquisition without any fear that the IRS will assert that Section 1031(a)(2)(E) applies.

The use of a grantor trust in such situations, however, requires that the ownership interest that is acquired is in a trust (within the meaning of Reg. 301.7701-4(c)) and not in a business entity. The IRS expressly warned in Rev. Rul. 2004-86 that it would have reached a completely different conclusion if the trustee had been given additional powers under the agreement. Specifically, the trust would have been classified as a business entity (under Reg. 301.7701-3) if the trustee had been given the power to do one or more of the following:

- Dispose of Blackacre and acquire new property.
- Renegotiate the lease with Mary.
- Enter into leases with tenants other than Mary (except in the case of Mary's bankruptcy or insolvency).
- Renegotiate the obligation used to purchase Blackacre.
- Refinance the obligation used to purchase Blackacre.
- Invest cash received to profit from market fluctuations.
- Make more than minor non-structural modifications to Blackacre that were not required by law.

If the trustee had the power to commit any one of these "seven deadly sins," or if the trustee could vary the investments of the trust (for example, by obtaining additional property or money from the beneficiaries), the trust would have been classified as a business entity. Furthermore, because the assets of the trust would not be owned by the beneficiaries as co-owners under state law, the trust would not be able to elect out of Subchapter K under Section 761.[20]

The limitation on the powers of a trustee of a trust is a very important part of Rev. Rul. 2004-86. It is not sufficient that the trustee never commits one of the "seven deadly sins" that would cause classification of the trust as a business entity—the trustee must lack the power to undertake those actions. This aspect of Rev. Rul. 2004-86 is consistent with the case law in which a trust is classified in accordance with the powers that the trustee has under the trust agreement and without regard to what actions, if any, the trustee has performed other than to conserve and protect the property of the trust.

It must be emphasized that there is no relationship between the requirements that apply to a DST and the requirements that apply to a TIC. Each involves multiple ownership of property for purposes of a like-kind exchange, but there the relationship stops. A DST is an entity that seeks to be disregarded for tax purposes (because it is classified as a trust), whereas a TIC involves a non-entity owned by multiple persons (tenants in common) who are seeking to avoid partnership classification. It is easy to think that a DST must satisfy the requirements of Rev. Proc. 2002-22, and that Rev. Rul. 2004-86 somehow applies to a TIC arrangement, but that simply is not accurate.

Nevertheless, it still is necessary to avoid classification of a DST arrangement as a partnership. The owners of beneficial interests in a

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20 Reg. 1.761-2(a)(2)(i).

DST could be treated as partners if there were unequal sharing, for example, or if the sponsor were somehow subject to their obligations. Thus, if the lender with respect to a DST transaction wanted to impose recourse liability on the sponsor as a result of violations by the owners of beneficial interests, the question would arise whether there was improper risk shifting that could give rise to a partnership. The issues that arise in structuring a TIC interest—to prevent a partnership from arising—apply in the DST context, even if Rev. Proc. 2002-22 does not.

Although DSTs have been approved by the IRS, the limitations set forth in Rev. Rul. 2004-86—particularly the seven deadly sins—will make it difficult to use a DST in some situations. Because a DST is a separate legal entity that holds fee title to the property, it is more "efficient" from a lending perspective than a TIC arrangement (where there are multiple owners of interests in the property), so that a DST could be useful. As a practical matter, however, the beneficiaries of a DST are not permitted to contribute any funds to the DST to address the routine financial needs that arise in connection with the ownership and operation of rental properties. As a result, the DST is most useful for holding real estate investments where additional capital is not needed, e.g., a triple net lease to a "credit tenant"[21] (such as a Wal-Mart store) or an investment in land that is then leased to a user (e.g., a long-term ground lease).

Even where it is not expected that any additional funding will be needed, bad events can arise (who would have thought that Lehman Brothers or AIG would collapse?). To address these situations, most DSTs contain a "lifeboat" provision—if the assets of the DST are imperiled due to unexpected circumstances, the trustees of the DST are authorized to contribute the assets to a partnership or LLC (often referred to as the "kickout LLC") and then distribute assets in the kickout LLC to the beneficiaries in liquidation of the trust.[22] This approach appears to be consistent with both the letter and spirit of Rev. Rul. 2004-86, and it is also consistent with prior rulings from the IRS in which a trust was permitted to contribute its assets to a corporation and then distribute the corporate stock in liquidation. No authorities expressly permit this provision in a DST, although it has become quite common.

One of the problems with a kickout is that it effectively terminates the DST. If a DST owns multiple properties (which is one of the advantages of the DST) and only one of the properties encounters difficulties that make a kickout necessary, how can the DST take the actions with respect to the one property without either tainting the entire structure or requiring a kickout of all of the properties?

This problem has been solved through the "double stack,"[23] in which there are two layers of DSTs—investors own interests in a master trust, which in turn owns a series of property trusts, each of which holds one of the properties. By using this structure, the investors are treated as owning an undivided interest in all of the properties. If a problem arises with one of the properties, the DST can simply kick out the troubled property while retaining all of the good properties. With this structure, the distribution of some but not all of the properties of a DST appears to be permissible as long as the distribution is pro rata.

A DST has only the right to make *minor, non-structural improvements* to the property, unless otherwise required by law. (Clearly, *repairs* can be made to maintain the property in its condition at the time of contribution). Rev. Rul. 2004-86 provides little guidance on the scope of this limitation. One interpretation would be that the DST (1) is not permitted to

Practice Notes

- The conclusion that can be drawn from the cases and rulings involving swap and drop transactions is the same as that can be drawn from the authorities concerning drop and swap transactions—the courts have approved these transactions even if the IRS has not. Moreover, the Service's reasoning in its old, litigation-related Rulings is questionable, whereas the courts have looked at the rationale underlying the statute and approved the exchanges.
- The net effect of the rigorous rules established by the Service in TAM 200602034 is that it will be very difficult to satisfy the like-kind exchange rules in the case of exchanges of intangible property, except in the narrow situation in which the exchangers are engaged in the same line of business and, moreover, where the nature of the underlying assets of the two companies is similar.
- If all the partners cannot agree concerning a like-kind exchange, one of the easiest solutions is to have the exchanging partners acquire the partnership interests of the non-exchanging partners immediately before the relinquished property is sold. The purchase can be structured as a redemption using a note secured by the property, so that the buyer's money can be used to fund the redemption. The price of the replacement property, however, will need to cover the entire sale price of the relinquished property (and not just the value attributable to the exchanging partners).

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[21] A "credit tenant" is one that has issued "investment grade" debt instruments which have been rated by one of the major rating agencies.

[22] Alternatively, some DSTs will provide that the trustees have the right to convert the DST into an LLC under state law, which should have the same tax effect, although a mere conversion might be viewed more skeptically by the IRS.

[23] The description of this technique as a "double stack" was first used by Arnold Harrison, Esq., of Jenner & Block in Chicago.

make structural modifications, even if they are minor, and (2) is not permitted to make more than minor non-structural modifications.

The scope of the exception for modifications "otherwise required by law" also is unclear. At one extreme, it is possible to argue that any improvement that improves health and safety is covered by the exception and, as a result, only purely cosmetic modifications fall outside of the exception. At the other extreme, the exception could be interpreted to extend only to modifications necessary to avoid violating minimum health and safety standards.

Finally, it is unclear what constitutes a "structural" as opposed to a "non-structural" modification under Rev. Rul. 2004-86. The Ruling provides no guidance on this point. While alterations to the foundation, perimeter, load-bearing walls, and roof structure of a building would appear to constitute structural modifications, it is unclear whether the following examples, which illustrate the complex factual issues resulting from the lack of a clear definition, would constitute structural modifications:

- Creation of a platform for new office space at an industrial warehouse facility.
- Constructing an additional bay door at an industrial facility.
- Adding skylights to a roof to provide for additional light in a building.
- Construction of a new bathroom in a building, including the addition of new plumbing.
- Moving a bathroom at a building, including installing new plumbing or moving existing plumbing.
- Addition of a sign at a retail property.
- Construction of a kiosk at a retail property or a guardhouse and gate at a residential property.

In the absence of a formal definition, the determination of whether a modification is structural or non-structural should be given its ordinary meaning.

The limitations discussed above make DSTs more suitable for offerings of certain types of property and less suitable for others. The ideal property for a DST is a commercial property, leased to a single creditworthy tenant pursuant to a long-term, triple-net lease, or an investment in land that is leased to an end-user under a long-term ground lease. Nevertheless, because it may be easier to obtain financing for a DST offering than a TIC offering in the current lending environment, there is increasing interest in the use of DSTs for offerings of other property types, including commercial, industrial, and retail properties as well as multi-family apartment buildings. Some properties (such as apartments) are better than others for DSTs, but it can be anticipated that the usage of DSTs will continue to grow for like-kind exchanges.

FUNDS HELD BY QIs

Treasury and the IRS recently issued final Regulations on the tax treatment of Section 1031 qualified escrow accounts and qualified trusts.[24]

Originally, Proposed Regulations issued in 1999 generally provided that the taxpayer (the transferor of the property) was the owner of the assets in a qualified escrow account or qualified trust and had to take into account all items of income, deduction, and credit (including capital gains and losses) of the qualified escrow account or qualified trust. If, however, under the facts and circumstances, a QI or transferee had the beneficial use and enjoyment of the assets, then the QI or transferee was the owner of the assets in the qualified escrow account or qualified trust and had to take into account all items of income, deduction, and credit (including capital gains and losses) of the qualified escrow account or qualified trust.

The 1999 Proposed Regulations further provided that, if a QI or transferee was the owner of the assets transferred, the transaction might be characterized as a below-market loan from the taxpayer to the owner to which Section 7872 might apply. By their terms, the 1999 Proposed Regulations did not apply to QI funds that were not held in a qualified escrow account or qualified trust.

These proposals were withdrawn and were replaced by new Proposed Regulations in 2006. The 2006 Proposed Regulations, which treated the funds held by a QI as a loan for tax purposes, were very controversial and resulted in boisterous hearings and commentary. In finalizing the Regulations, Treasury and the IRS retained the core principle of the Proposed Regulations (amounts held by the QI are generally treated as a loan from the taxpayer to the QI, with imputed interest being determined if the interest rate paid by the QI is insufficient), but with exceptions that essentially gutted the primary rule.

Specifically, under the final Regulations, the deemed loan from the taxpayer to the QI is exempt from the imputed interest rules if the loan is for an amount less than $2 million and will be outstanding for six months or less. Any loan that is not subject to this exemption will be tested for imputed interest using a special 91-day applicable federal rate (AFR) that is equal to the lesser of the short-term AFR under Section 7872 or the investment rate on a 13-week Treasury bill. The expectation is that these rules will essentially prevent imputed interest on most funds held by QIs who are parties to a like-kind exchange.

CONCLUSION

As practitioners exercise their ingenuity, new issues and opportunities continue to arise in connection with Section 1031 nonrecognition exchanges. New guidance from Treasury, the IRS, and the courts will continue to ensure that this area of the tax law is in no danger of becoming static. ■

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[24] TD 9413, 7/9/08. See generally Weller and Marques, "Final Regulations Reach Compromise on Taxation of Like-Kind Exchange Accounts," 109 JTAX 199 (October 2008).