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

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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.

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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-

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