THE 'STATE OF THE ART' IN LIKE-KIND EXCHANGES, 2012

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Complications, variations, nuances, and idiosyncrasies abound in the rules that govern nonrecognition exchanges. Different types of property (real, personal, intangible), different types of entities having ownership, and different forms of exchanges (deferred, reverse, swap and drop, drop and swap) all may affect the bottom line, which is whether the taxpayer can defer recognizing gain.

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A little more than 12 years ago, the first article on the "state of the art" in like-kind exchanges appeared in THE JOURNAL. It was followed in 2003 by an updated discussion of the techniques available to defer gain on exchanges of real property and other assets, a third installment in 2006, and a fourth installment in 2009.[1] In the three years since, there have been many additional developments in the law.

The latest guidance from the Service and the courts will be examined below, along with some questions that always seem to arise. The matters discussed include:

- What property can be exchanged.
- Reverse exchanges.
- When a taxpayer can acquire replacement property from a related party.
- Default by a qualified intermediary (QI) in a like-kind exchange.
- Underwater like-kind exchanges.
- 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, with any level of comfort, exchange property received in a nontaxable distribution from a partnership (a "drop and swap" transaction).
- 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%, and 95% rules).
- The tax treatment of funds held by a QI.
- Transfers of property to regulated investment companies (RICs) or real estate investment trusts (REITs).

BACKGROUND

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

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

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

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

Liabilities. Taxable boot includes relief from liabilities. Reg. 1.1031(d)-2 expressly permits a taxpayer to 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 concerning the types of property that qualify as replacement property in a like-kind exchange.

Vehicles. In Ltr. Rul. 200912004, the IRS concluded that cars, light general purpose trucks (i.e., unloaded weight of less than 13,000 pounds), and vehicles in between (e.g., crossovers, sport utility vehicles, minivans, cargo vans) are of like-kind for purposes of Section 1031, given that the distinctions between cars and light-duty trucks that existed during the last century have been reduced significantly by the gradual introduction of "crossover" vehicles. In addition, federal regulators increasingly treat cars and light-duty trucks alike for fuel economy and emissions standards.

Disregarded entities. 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.

For example, in Ltr. Rul. 200807005, 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.

Vacation and single-family rental property. 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:

It now seems clear and indisputable that entities that are disregarded for federal income tax purposes are disregarded for purposes of Section 1031.

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 of 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]

The Tax Court revisited this issue in *Goolsby,* TCM 2010-64, which involved an exchange of one rental property for another property that the taxpayers attempted to rent. After two months in which they failed to rent the second property, the taxpayers moved into the property. Un-

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[1] See 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); Lipton, The 'State of the Art' in Like-Kind Exchanges, 2006," 104 JTAX 138 (March 2006); and Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2009," 110 JTAX 27 (January 2009).

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

persuaded that the taxpayers held the replacement property for investment or for productive use in a trade or business at the time of the exchange, the Tax Court held that the taxpayers had to recognize gain to the extent of the FMV of the property received.

Citing *Moore*, the court required that investment intent be the taxpayers' primary motivation for holding the exchanged property in order for the property to qualify as held for investment purposes. The taxpayers failed to meet this standard, as evidenced by the following facts:

In a ruling involving two disregarded entities, the acquisition of the replacement property by the entity that did not own the relinquished property still qualified.

- Before the exchange, the taxpayers never researched rental opportunities in the area.
- The taxpayers never inquired whether their neighborhood association would allow them to rent the property.
- The taxpayers' only effort to gain exposure for the property was to place an advertisement in a neighborhood newspaper for a few months.
- The taxpayers permanently moved into the replacement property within two months after they acquired it (rather than temporarily move in until renters could be found).
- The taxpayers made the purchase of the replacement property contingent on the sale of their former personal residence.
- Before purchasing the property, the taxpayers sought advice from their QI regarding whether they could move into the property if renters could not be found.
- The taxpayers began preparations to finish the basement of the property, having a builder obtain permits for the construction, within two weeks of purchasing the property.

Thus, before the exchange, the taxpayers contemplated the use of the property as a personal residence. The Tax Court further noted that even though Rev. Proc. 2008-16 went into effect after the exchange in *Goolsby* took place, the safe harbor still would have been inapplicable because the replacement property was never rented.

As evident from *Goolsby*, merely designating property as rental property is not enough to meet the held-for-investment standard of Section 1031. For example, although the taxpayer in CCA 201025049 held some of its equipment for rent, a substantial amount of the equipment designated as rental equipment was sold relatively soon after acquisition and prior to the equipment's generating any rental income. At best, the IRS said that for a relatively short period, the taxpayer rented or held for rent some of its equipment pending the sale of that equipment. Therefore, the exchanges of the equipment were ineligible for nonrecognition treatment by reason of Section 1031(a)(2)(A), which excludes property held primarily for sale.

Intangible property. Three 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.

Most recently, in Ltr. Rul. 200901020 the IRS concluded that residential density development rights were like-kind property to a fee interest in real estate, a leasehold interest in real estate with 30 years or more remaining, and land use rights for hotel units (to be applied to property already owned by the taxpayer). In effect, the taxpayer exchanged one set of development rights for other development rights, as well as another fee interest in land and another long-term leasehold interest in additional real property. Of relevance was the fact that the development rights were in perpetuity and were directly related and requisite to the taxpayer's interest, use, and enjoyment of the underlying land. Although not necessarily determinative for purposes of Section 1031, the IRS also noted that the development rights were interests in real property under state law.

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

Multiple properties. Reg. 1.1031(j)-1 provides rules for the treatment of exchanges of multiple properties. As a general rule, the application of Section 1031 requires a property-by-property comparison for computing the gain recognized and the basis of property received in a like-kind exchange. In an exchange of multiple properties, however, the properties transferred and the properties received are separated into "exchange groups" (and a residual group if the aggregate FMV of the properties

transferred in all of the exchange groups differs from the aggregate FMV of the properties received in all of the exchange groups). Each exchange group consists of the properties transferred and received in the exchange that are of a like-kind or like class. Ltr. Rul. 200901004 provides a simple illustration of the rules of Reg. 1.1031(j)-1.

EXAMPLE: A taxpayer exchanges property A, having an FMV of $100, and property B, having an FMV of $250, for property C, which has an FMV of $85, and property D, which has an FMV of $265. Property A is of like-kind to property C (but not to property D), while property B is of like-kind to property D (but not property C). The exchanging taxpayer has a zero adjusted basis in properties A and B. As a result, even though there is an exchange of like-kind properties worth $350, the taxpayer is considered to have received $15 of non-like-kind property. That is, since property A with an FMV of $100 was exchanged for property C worth $85, the exchanging taxpayer is considered to have received $15 worth of property D for property A, and property D is not of like-kind to property A. Consequently, the taxpayer has $15 of gain that is not deferred under Section 1031.

The court required that investment intent be the taxpayers' primary motivation for holding the exchanged property.

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 and ultimately 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.

There have been some recent developments concerning the safe harbors of Reg. 1.1031(k)-1(g), the use of which will result in a favorable determination that a taxpayer is not in actual or constructive receipt of money or other property for purposes of Section 1031.

Ltr. Rul. 200908005. In Ltr. Rul. 200908005, a bank engaged in the business of serving as a QI and as an exchange accommodation titleholder (EAT) in like-kind exchanges acquired three wholly owned subsidiaries of an S corporation that also acted as QIs in large-volume, repetitive like-kind exchange programs. The IRS concluded that the conversion of the tax status of the three subsidiaries from qualified S corporation subsidiaries into C corporations as a result of the bank's acquisition did not cause the subsidiaries to be treated as new or different QIs for purposes of Reg. 1.1031(k)-1(g)(4).

Ltr. Rul. 201030020. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For example, in Ltr. Rul. 201030020, a national banking association was allowed to combine its services as QI and as trustee of qualified trusts. The fact that the association served in both capacities in the same transaction was not a disqualification of either safe harbor and did not make the association a disqualified person under the Regulations.

Crandall. The Tax Court stressed the importance of following formalities when using a qualified escrow account to avoid the constructive

receipt of money or property. In *Crandall,* TC Sum. Opn. 2011-14, taxpayers attempted to use a qualified escrow account to avoid recognizing gain on the sale and purchase of like-kind real property. The escrow agreements, however, did not limit the taxpayers' right to receive, pledge, borrow, or otherwise obtain the benefits of the funds, as required by Reg. 1.1031(k)-1(g)(3).

Despite the taxpayers' argument that the funds in the escrow account were held solely for the purchase of the replacement property and that they received no proceeds from the sale of the relinquished property, the lack of express limitations in the escrow agreement resulted in the taxpayers' being treated as having constructively received the proceeds. As a result, the transaction did not qualify for Section 1031 nonrecognition.

Morton. The taxpayer in *Morton,* 107 AFTR2d 2011-1963 (Fed. Cl. Ct., 2011), co-founder of the Hard Rock Hotel and Casino in Las Vegas, sought to effect a deferred like-kind exchange of a private aircraft by entering into an exchange agreement with a QI and an escrow agreement with an escrow agent. The escrow agent accidentally and in contravention of the escrow agreement wired funds from the escrow account to an S corporation owned by the taxpayer. The taxpayer returned the funds the following day, but the IRS contended that because the taxpayer had possession and control over the funds, he had actual receipt of them.

The Tax Court did not agree that an accidental transfer followed by an immediate return of funds constituted actual or constructive receipt. Of significance was the fact that the taxpayer was bound by contract not to receive, pledge, borrow, or otherwise obtain the benefits of the funds for at least 45 days. Further, the court felt that the taxpayer should not be penalized for the mistaken actions of a third party. Because the taxpayer complied with all the requirements of the QI safe harbor over which he had control, the Tax Court concluded that he validly effected a deferred like-kind exchange.

REVERSE EXCHANGES

As with deferred exchanges, 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 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 an exchange-last exchange, in which the AP acquired and held the replacement property until the taxpayer found a purchaser for the relinquished property, or as an exchange-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.

Rev. Proc. 2000-37 does not distinguish between exchange-first and exchange-last transactions. Although most reverse exchanges are structured using the exchange-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 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 the Procedure 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 an exchange-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

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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).

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 allowed the title companies and exchange accommodators that had been serving as QIs to provide one-stop shopping. The same person may serve as the EAT for the acquisition of the replacement property and the QI in the sale of the relinquished property.

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

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

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

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

Partnership interests. In Ltr. Rul. 200909008, the IRS concluded that the acquisition of a partnership interest by an EAT was not inconsistent with the entity's status as an EAT where the remaining partnership interest already was owned by the taxpayer engaged in the like-kind exchange, and under Rev. Rul. 99-6 the taxpayer will be treated as acquiring an undivided interest in the assets held by the partnership on acquisition of the remaining partnership interest not previously owned.

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. Unfortunately, the IRS has shown no indication that it will modify Rev. Proc. 2000-37 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 an exchange-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 purpose.

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.

Merely designating property as rental property is not enough to meet the held-for-investment standard of Section 1031.

Most of the "form" agreements that are used by EATs provide that the EAT will be treated as the taxpayer's agent for state and local tax purposes, so that any transfer of the replacement property to the EAT will be treated as a transfer of the property to the taxpayer for local real estate transfer tax purposes. This is an attempt to avoid double transfer taxes when an EAT acquires the replacement property from the taxpayer (in an exchange-last transaction) or when the EAT acquires the relinquished property from a third party (in an exchange-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]

Identification periods. 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 taxpayers 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

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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.

qualified as replacement property for this relinquished property. Thus, 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. But consider a taxpayer that initially acquires replacement property through an EAT, and 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?

Twelve 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 argue 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.

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

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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). See, e.g., Ltr. Ruls. 200919027 and 200920032, which involved farmland inherited equally by three siblings as tenants in common. The siblings' interests in the farmland were held in trust. After the death of one of the siblings, the trusts agreed to exchange each of their undivided interest in the farmland for 100% fee simple interests in the same property, so that the trust of the deceased sibling could sell its parcel to a third party. The IRS concluded that there was no exchange between related persons for purposes of Section 1031(f)(1). Although the two living siblings were related persons under Section 267(b), neither intended to sell their respective property within two years of the exchange. Further, while the trust of the deceased sibling intended to sell its interest within two years of the exchange, the living siblings were not related to such trust or its trustees within the meaning of Section 1031(f)(3).

restrictions of Section 1031(f), Section 1031(f)(4) prevents 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 Brothers, Ltd.*, 124 TC 45 (2005), *aff'd* 580 F.3d 1038, 104 AFTR2d 2009-6274 (CA-9, 2009), *cert. den.*,[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 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.

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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).

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 the 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 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.

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 exchange 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 Service 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.

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 Service 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 has 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.

CCA 201013038. In CCA 201013038, the IRS concluded that a transaction did not constitute a like-kind exchange eligible for nonrecognition treatment because the transaction was structured to avoid the Section 1031(f) restrictions on exchanges between related parties. The related parties involved in the transaction included the taxpayer, who leased equipment to unrelated customers, and a related dealer that sold the same type of equipment. Under a master exchange agreement, the taxpayer used a QI to exchange its old equipment for new equipment.

For example, if the taxpayer owned an old off-road truck with an FMV of $750,000 and an adjusted basis of $150,000, and the dealer owned a new off-road truck with an FMV of $760,000 and an adjusted basis of $760,000, the taxpayer would enter into an exchange agreement to have a QI sell the old truck to a customer for $750,000, and buy the new truck from the dealer for $760,000 using the $750,000 proceeds from the sale of the old truck, plus $10,000 from other sources. The taxpayer intended to defer the $600,000 gain inherent in the old truck.

Nevertheless, the IRS found the transaction to be the economic equivalent of a related-party ex-

change described in Section 1031(f)(1). In other words, the taxpayer interposed the QI to accomplish what Section 1031(f)(1) would prevent. The related-party group consisting of the taxpayer and the dealer began with two properties (the old truck and the new truck) and, following a series of transactions, owned just the new truck and received cash for the old truck. The taxpayer tried to avoid recognizing gain on the exchange of the low-basis old truck for the new truck, while the dealer realized little or no gain on its taxable sale of the high-basis new truck. The IRS found the taxpayer's structure to be almost identical to the facts of Rev. Rul. 2002-83, and similar to the situation in that Ruling, the taxpayer and the dealer attempted to exchange old equipment for new equipment and then "cash out" of the old equipment. Further support for the Service's conclusion was found in *Teruya Brothers* and *Ocmulgee Fields, Inc.*, 132 TC 105 (2009) (both discussed in more detail, below).

In its analysis, the IRS concluded that the transaction did not meet the Section 1031(f)(2)(C) exception to the restrictions on exchanges between related parties. Despite asserting independent business reasons and considerations (e.g., the dealer received incentives from the manufacturer for all sales, and the taxpayer patronized the dealer (a related party) rather than the manufacturer or another dealer to obtain the incentives for the dealer; convenience; goodwill; established customer relationship; the possibility of financing discounts) the taxpayer could not establish that tax avoidance was not one of its principal purposes in structuring the transactions.

The Service relied on the legislative history of the non-tax-avoidance exception in Section 1031(f)(2)(C), which provides that the exception generally applies to (1) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties, (2) dispositions of property in nonrecognition transactions, and (3) transactions that do not involve the shifting of basis between properties.

Although the taxpayer's transactions did not fall within the first two categories, the exchange clearly resulted in basis shifting: the dealer sold inventory into the exchange at its cost (realizing no gains), while the taxpayer attempted to defer its gain from the disposition of the old equipment by taking a substitute basis (the high basis of the new equipment for the low basis of the old equipment). Therefore, even though the taxpayer may have had some non-tax-avoidance (independent business) reasons for structuring the exchange, the IRS found it clear that immediate tax reduction (through deferral) was also one of the taxpayer's principal objectives. Consequently, the Section 1031(f)(2)(C) exception did not apply.

Ltr. Rul. 201027036. Ltr. Rul. 201027036 involved a like-kind exchange among related parties across international borders. The taxpayer in the ruling conducted a global commercial product leasing business. An international subsidiary of the taxpayer entered into an exchange agreement with a QI to transfer relinquished property to two domestic subsidiaries of the taxpayer. Within two years of acquiring the relinquished property, the domestic subsidiaries dismantled and sold parts of the relinquished property to unrelated third parties. The international subsidiary acquired like-kind replacement property through the QI from an unrelated domestic corporation.

The IRS ruled that Section 1031(f) did not preclude nonrecognition treatment in the transaction. Section 1031(f)(1) was not applicable because the international subsidiary exchanged property with an unrelated QI. In addition, Section 1031(f)(4) did not apply because the international subsidiary and the domestic subsidiaries did not exchange properties directly or through a QI. The domestic subsidiaries did not own, prior to the exchange, any property that the international subsidiary acquired in the exchange. Moreover, the international subsidiary did not transfer the relinquished property to the domestic subsidiaries as part of a transaction or series of transactions structured to avoid the purposes of Section 1031(f)(1). The related parties also did not exchange high-basis property for low-basis property in anticipation of the sale of the low-basis property. Accordingly, the disposal of the relinquished property parts within two years of the acquisition did not result in a "cashing out" of an investment or shifting of basis between the parties.

The development rights were in perpetuity and were directly related and requisite to the taxpayer's interest, use, and enjoyment of the underlying land.

The IRS further ruled in Ltr. Rul. 201027036 that no amount of realized but unrecognized gain under Section 1031 would be treated as foreign base company income of the international subsidiary, as determined under Section 954, for the year in which the gain or loss was realized but not recognized. Because the income of a controlled foreign corporation (CFC) generally is computed as if the corporation were domestic, the results of a valid Section 1031 like-kind exchange are respected for purposes of computing the CFC's income. Accordingly, in a qualifying Section 1031 exchange, a CFC has income only to the extent of gain recognition under Section 1031, if any. Similarly, the Service ruled that no amount of realized but unrecognized gain (or loss) under Section 1031 would generate E&P (or a deficit in E&P) of the international subsidiary under Section 964 for the year in which such gain (or loss) was realized but not recognized, because the E&P of a foreign

corporation for Subpart F purposes generally is determined by rules substantially similar to those applicable to domestic corporations under Section 964(a) and Reg. 1.964-1(a).[9]

Ltr. Rul. 201048025. Ltr. Rul. 201048025 involved a REIT that owned and operated a number of commercial real estate properties, primarily through a wholly owned partnership, disregarded for tax purposes, and various disregarded entities wholly owned by the partnership.

The partnership entered into a deferred exchange agreement with a QI, providing for the exchange of the relinquished property with an unrelated third party. The sale proceeds for the relinquished property included boot in the form of cash and prepaid rent (treated as a liability assumed by the third-party buyer). Within 45 days after the sale of the relinquished property, the partnership identified certain potential replacement properties for completion of the deferred exchange. A number of the replacement properties were owned by a party related to the taxpayer and by disregarded LLCs wholly owned by the related party. Within 180 days from the date of conveyance of the relinquished property, the partnership caused the QI to acquire and transfer to the partnership a sufficient number of such replacement properties, which the partnership represented that it would hold for at least two years.

The related party also entered into a deferred exchange agreement with a QI to exchange the replacement properties that it transferred to the partnership. Within 45 days after the transfer of such properties to the partnership, the related party identified replacement properties of its own, including properties owned by third parties and properties owned by parties affiliated with or related to the related party (including the taxpayer). The related party acquired ownership of its replacement properties within 180 days from the transfer of its relinquished properties and represented that it would hold such properties for at least two years.

To the extent any of the related party's replacement properties were owned by an affiliate, the affiliate also entered into a deferred exchange agreement with a QI to exchange such properties. Within 45 days following the transfer of the affiliate's relinquished property to the related party, the affiliate identified replacement properties. All such replacement properties were owned by third parties unrelated to the taxpayer, the related party or the transferring affiliate. Each transferring affiliate acquired ownership of its replacement properties within 180 days from the transfer of the affiliate's respective relinquished property and represented that it would hold the properties received in its exchange for at least two years.

The IRS ruled that Section 1031(f) did not disqualify the like-kind exchanges described above provided that the taxpayer, the related party, and any affiliate undertaking an exchange hold their respective replacement properties for two years following the date of acquisition. It further ruled that receipt by the related party or any affiliate of boot in an amount less than a certain percentage of the total gain recognized in the exchanges did not cause Section 1031(f) to make the benefits of Section 1031(a) unavailable to the taxpayer.

The Service based its rulings on Section 1031(f)(2)(C), which provides that any second disposition by exchanging parties will not be taken into account for purposes of Section 1031(f)(1) if it can be established to the Service's satisfaction that neither the initial exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax. This test was satisfied because both the related party and any transferring affiliate also structured their dispositions of property as like-kind exchanges. Thus, neither Section 1031(f)(4) nor Rev. Rul. 2002-83 applied.

In other words, there was no material "cashing out" of any party's investment in real estate. On completion of the series of transactions, all related parties owned property that was like-kind to the properties they exchanged. None of the parties received cash or other non-like-kind property in return for the relinquished properties, other than a limited amount of boot, and the boot received by the related party and any affiliate was in a de minimis amount not greater than a certain percentage of the exchanging entity's realized gain. The IRS found this insufficient to support a conclusion that the exchanges were undertaken to avoid the purposes of Section 1031(f).[10]

Teruya Brothers

In *Teruya Brothers,* the Ninth Circuit affirmed the Tax Court's 2005 decision that two like-kind exchanges involving related parties did not qualify for nonrecognition treatment under Section 1031.

Facts. Teruya Brothers, a Hawaii corporation, engaged in two separate real property transactions, referred to by the Tax Court as the Ocean Vista transaction and the Royal Towers transaction. The Ocean Vista transaction involved a parcel of land underlying the Ocean Vista condominiums in Honolulu. The property was leased by Teruya Brothers to a ground lessee which, in turn, leased the property to a condominium association that desired to acquire fee simple title to the property.

Although Teruya Brothers originally refused to sell the Ocean Vista property to the association, it later agreed to sell the property provided that it was part of a like-kind exchange for a property owned by Times Super Market, Ltd. (TSM), which was owned 62.5% by Teruya

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[9] For a discussion of U.S. income recognition deferral opportunities under Section 1031 or 1033, and foreign income recognition deferral opportunities under similar provisions of foreign laws, see Lederman, "Nonsimultaneous Foreign Rollovers May Defer U.S. and Foreign Tax Simultaneously," 116 JTAX 161 (March 2012).

[10] For a discussion of the effect of Ltr. Rul. 201048025 on the 45-day identification and 180-day exchange periods and the amount of boot a related party may receive without triggering an abusive cash-out, see Alton, Borden, and Lederman, "Do Serial Exchangers Get Cash, With Extra Time to Boot, Under New Letter Ruling?," 114 JTAX 153 (March 2011).

Brothers. Indeed, the purchase of the replacement property from TSM, and the sale of the Ocean Vista property to the association, were mutual conditions in the contracts.

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

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

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

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

"Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031."[11]

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

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

Ninth Circuit. As noted above, in 2009, the Ninth Circuit affirmed the Tax Court's decision that the Ocean Vista transaction and the Royal Towers transaction did not qualify for nonrecognition treatment under Section 1031 because they were part of a series of transactions structured to avoid the purposes of Section 1031(f).

The appellate court first turned to Section 1031(f)'s legislative history. Relying on the same committee report as had the IRS and the Tax Court, the Ninth Circuit found that Congress wanted to accord nonrecognition treatment only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment and that Congress wanted to prevent related parties from taking advantage of Section 1031(d)'s basis-shifting provisions to avoid gains or accelerate losses on cashed-out investments. With this legislative background in mind, the Ninth Circuit concluded that the Ocean Vista transaction and the Royal Towers transaction were structured to avoid the purposes of Section 1031(f)(4).

The Ninth Circuit rejected Teruya Brothers' contention that the economic consequences of the transactions to TSM were irrelevant to its inquiry, and that Teruya Brothers' continued investment in real property was dispositive. According to the Ninth Circuit, the changing economic positions of Teruya Brothers and TSM readily showed that the related parties used the exchanges to cash out of an investment in low-basis real property. All in all, Teruya Brothers and TSM decreased their investment in real property by approximately $13.4 million, and increased their

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11 H. Rep't No. 101-247, *supra* note 7, page 1341.

cash position by the same amount. Finding that Teruya Brothers could have achieved the same property dispositions through far simpler means, the Ninth Circuit concluded that the transactions took their peculiar structure for no purpose except to avoid Section 1031(f).

The Ninth Circuit next addressed Teruya Brothers' argument that Section 1031(f)(2) provides an additional limitation on Section 1031(f)(4)'s scope, agreeing with the Tax Court that any inquiry into whether a transaction is structured to avoid the purposes of Section 1031(f) should also take the exception of Section 1031(f)(2) into consideration. Because transactions falling within Section 1031(f)(2)'s exceptions by their very nature do not violate the purposes of Section 1031(f)(1), Section 1031(f)(2) independently limits Section 1031(f)(4)'s scope.

Despite this determination, the Ninth Circuit concluded that the improper avoidance of federal income tax was one of the principal purposes behind the Ocean Vista transaction and the Royal Towers transaction. The economic unit of Teruya Brothers/TSM achieved far more advantageous tax consequences by employing like-kind exchanges than it would have had Teruya Brothers simply sold its properties to third-party buyers itself. If Teruya Brothers sold Royal Towers directly, it would have had to recognize nearly $11 million in gain, far less than the $2.2 million of gain recognized by TSM with the transaction presented as a like-kind exchange. Moreover, TSM paid no tax on even this smaller gain, as it was able to carry over NOLs from previous years. Similarly, in the Ocean Vista transaction, though TSM recognized gain virtually identical to that which Teruya Brothers deferred, TSM paid no tax due to its NOLs.

Lastly, the Ninth Circuit noted that Teruya Brothers' undisputed intent to complete successfully a like-kind exchange was irrelevant to whether the transactions were structured to avoid Section 1031(f)'s purposes. Moreover, by focusing only on its own continued investment in like-kind property, Teruya Brothers ignored the crucial tax consequences of the exchanges to its related party, TSM.

Ocmulgee Fields

In *Ocmulgee Fields*, the Tax Court had another opportunity to consider whether a taxpayer can acquire replacement property from a related party in a Section 1031 like-kind exchange. Its decision that Section 1031(f)(4) disallowed nonrecognition treatment for the exchange was later affirmed by the Eleventh Circuit (613 F.3d 1360, 106 AFTR2d 2010-5820 (CA-11, 2010)).

Facts. Ocmulgee Fields, Inc. (OFI), a Georgia corporation, owned the Wesleyan Station Shopping Center and part of the Rivergate Shopping Center in Macon, Georgia, among other commercial real properties in Macon and surrounding areas. One other such property was called the "Barnes & Noble Corner," a piece of undeveloped real property located near Rivergate, which OFI owned until it was sold in 1996 to Treaty Fields, LLC (Treaty Fields), a Georgia LLC related to OFI.

On 7/17/03, OFI entered into an agreement (the "McEachern agreement") for the sale of Wesleyan Station to Scott Wilson and trusts established under the will of Wilson's father-in-law, John McEachern. The McEachern agreement provided that the purchase price for Wesleyan Station would be $7.25 million, the closing would take place on or before 10/10/03, and that OFI intended to structure the transaction as a like-kind exchange and could assign its interest to a QI.

On 10/9/03, OFI engaged Security Bank to act as a QI, who pursuant to the McEachern agreement sold Wesleyan Station. After considering and rejecting (for various reasons) at least six possible replacement properties presented by various real estate brokers, OFI and Treaty Fields entered into a contract for the purchase of the Barnes & Noble Corner on 10/15/03. OFI subsequently assigned its rights under that contract to Security Bank, as QI. On 11/4/03, Treaty Fields sold the Barnes & Noble Corner to Security Bank for $6,740,900, and because Treaty Fields had a basis in the property of $2,554,901, the gain recognized by Treaty Fields was $4,185,999. Security Bank then conveyed the Barnes & Noble Corner to OFI as replacement property for Wesleyan Station.

On its tax returns for the year ended 5/31/04, OFI reported that its adjusted basis in Wesleyan Station was $716,164, and since the sale price of Wesleyan Station was $6,838,900, OFI's gain was $6,122,736. OFI also reported that its basis in the replacement property (Barnes & Noble Corner) was the same $716,164. OFI treated this transaction as a valid Section 1031 exchange. The IRS determined that the transaction did not satisfy the requirements of Section 1031 on the grounds that Section 1031(f) applied. The Service also asserted an accuracy-related penalty.

The taxpayer contended, in contrast, that on or before the date it entered into the McEachern agreement, OFI planned to replace Wesleyan Station with replacement property acquired from an unrelated party. Only when its search for appropriate replacement property proved unfruitful did OFI consider replacing Wesleyan Station with Barnes & Noble Corner. It chose to do so for business reasons (to unite its ownership of Barnes & Noble Corner with the rest of Rivergate), notwithstanding that the sale of Barnes & Noble Corner would result in higher taxes than would otherwise occur (because the sale of the Barnes & Noble Corner would be taxable).

The Service argued, in contrast, that this case was similar to *Teruya Brothers*, in which the Tax Court found that a sale of property did not qualify for nonrecognition under Section 1031(a) when the replacement property was acquired from a related party, notwithstanding that the sale was technically made through an unrelated QI.[12] The court applied Section 1031(f)(1) to that transaction by disregarding the QI and treating the transaction as an

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12 See generally Cuff, *supra* note 8.

exchange between related parties that was structured to avoid the purposes of Section 1031(f)(1).

Tax Court. The Tax Court viewed *Ocmulgee* as requiring, first, a determination whether the transaction was covered by the anti-abuse rule in Section 1031(f)(4) and second, if that provision applied, whether one of the exceptions set forth in Section 1031(f)(2) could alter the result. More succinctly, the court stated that gain would be recognized by OFI on its exchange of Wesleyan Station for the Barnes & Noble Corner if the exchange was part of a transaction or series of transactions structured to avoid the purposes of Section 1031(f), taking into account the history of that provision as well as the Tax Court's prior decision in *Teruya Brothers*.

The safe harbors have resulted in the creation of an entire industry—QIs and title companies that stand ready to assist taxpayers in completing deferred exchanges.

According to the Tax Court, the purpose of Section 1031(f)(1) was to prevent transactions in which a taxpayer who anticipated the sale of low-basis property exchanged that property for high-basis property owned by a related person, with the related person then selling the property received in the exchange at a reduced gain (or possibly a loss) as a result of the rule in Section 1031(d) that property acquired in a like-kind exchange generally takes the basis of the property relinquished. The *Ocmulgee* court quoted the *Teruya Brothers* opinion: "Congress concluded 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." Furthermore, Section 1031(f)(4) was enacted in response to Congress's concern that related persons not be able to circumvent the purposes of Section 1031(f)(1) by interposing an exchange with an unrelated third party.

The Tax Court concluded in *Ocmulgee* that the situation was similar to *Teruya Brothers* because OFI exchanged Wesleyan Station with a QI for replacement property (the Barnes & Noble Corner) formerly owned by a related party, Treaty Fields. To determine whether the exchange was part of a transaction structured to avoid the purposes of Section 1031(f), the Tax Court considered how OFI would have fared had it instead exchanged Wesleyan Station with Treaty Fields for the Barnes & Noble Corner, and Treaty Fields had sold Wesleyan Station. Because that transaction would be squarely described in Section 1031(f)(1), the transaction would be taxable unless the taxpayer could establish that the deemed sale of Wesleyan Station did not have avoidance of federal income tax as one of its principal purposes (within the meaning of Section 1031(f)(2)(C)).

The legislative history of Section 1031(f)(2)(C) indicated that the non-tax-avoidance exception to Section 1031(f)(1) would apply to, among others, transactions that do not involve the shifting of basis between properties. In the *Ocmulgee* transaction, however, if Treaty Fields had received Wesleyan Station from OFI in exchange for the Barnes & Noble Corner, Treaty Field's adjusted basis of $2,554,901 in the Barnes & Noble Corner would have shifted to Wesleyan Station, which had a basis of only $716,164 in the hands of OFI. Because of that step-up in basis, Treaty Fields would have realized a gain on the sale of Wesleyan Station approximately $1.8 million less than OFI would have realized without the exchange. The court emphasized that while the legislative history of Section 1031(f)(2) identified transactions not involving basis shifting as transactions generally lacking tax avoidance as a principal purpose, a fair inference is that federal income tax avoidance generally is a principal purpose of transactions involving basis shifting.

The Tax Court rejected five "monumental" tax factors identified by OFI to override the basis differential:

- First, although there was an immediate tax on Treaty Fields' sale of the Barnes & Noble Corner, that tax was approximately equal to the tax it would have paid had it first exchanged the Barnes & Noble Corner for Wesleyan Station and then sold Wesleyan Station.
- Second, the acceleration of installment income to OFI, a result of the exchange, was not the addition of some new tax burden but merely the acceleration of a deferred tax, which was surely less than the amount of income accelerated (which, in turn, was less than the savings to OFI).
- Third, despite being entitled to less depreciation on the Barnes & Noble Corner than Treaty Fields had been allowed before the exchange, OFI did not give up any depreciable basis because its basis in Wesleyan Station shifted to the Barnes & Noble Corner, and Treaty Fields' basis was used to reduce gain on the sale.
- Fourth, with respect to the fact that OFI's tax rate was higher than the individual capital gains rate that applied to the partners in Treaty Fields, the court noted that if the transaction were recharacterized as an exchange first between OFI and Treaty Fields and then a sale by Treaty Fields, the lower tax rate would have applied. Moreover, the supposition as to the tax rate that would apply to OFI in the future was viewed by the Tax Court as too speculative to take into account.
- Fifth, OFI argued that the gain to one of its partners, who owned 70% of Treaty Fields, would have been eliminated on his death. This contention also was viewed by the court as too speculative to consider.

The court stated that there may be situations in which a taxpayer can overcome the negative inference to be drawn from basis shifting and a

"cash out," but this was not one of them. The Tax Court was not prepared to say that, as a matter of law, a finding of basis shifting precludes the absence of a principal purpose of tax avoidance. Where the transaction results in immediate tax savings, however, it will be difficult for the taxpayer to establish that tax avoidance was not a principal purpose of the deemed exchange.

The taxpayer attempted to counter these arguments by pointing to the business reasons for the exchange, which allowed OFI to reunite ownership of the Barnes & Noble Corner with the rest of Rivergate, yielding operating efficiencies and increasing the overall value of the reunited property. The taxpayer, however, failed to introduce any evidence to support this claim other than self-serving testimony, which the court disregarded. Moreover, even if there had been a legitimate business purpose for the acquisition of the Barnes & Noble Corner by OFI, that would not necessarily have precluded a finding that the exchange had as a principal purpose the avoidance of federal income tax.

The taxpayer also attempted to distinguish *Teruya Brothers* on the grounds that OFI did not structure its transaction by having a prearranged plan for the exchange with Treaty Fields; OFI had planned to acquire replacement property from unrelated parties but was unable to find any. The court rejected this argument, stating that even though there was a prearranged plan in *Teruya Brothers,* that was just one of the many ways in which a transaction could run afoul of Section 1031(f)(4). The court said that the determination of the tax consequences of the transaction depended on the hypothetical direct exchange of properties between OFI and Treaty Fields followed by a hypothetical sale by Treaty Fields of the property received, and as long as there was any income tax avoidance in that hypothetical transaction, Section 1031(f)(1) would apply to require gain recognition, the lack of a prearranged plan notwithstanding.[13]

The Tax Court viewed the end result of OFI's exchange of Wesleyan Station with Security Bank for the Barnes & Noble Corner as being the same as if OFI had first directly exchanged with Treaty Fields, which in turn sold Wesleyan Station to Security Bank. Because OFI did not show that the deemed transaction lacked a principal purpose of tax avoidance, the exchange was subject to gain recognition under Section 1031(f)(1) due to the application of the anti-abuse rule in Section 1031(f)(4).

Eleventh Circuit. Following the approach of *Teruya Brothers,* the Eleventh Circuit looked to the actual consequences of OFI's transactions to ascertain its intent. The Eleventh Circuit concluded that the substantive result of OFI and Treaty Fields cashing in on low-basis property (Wesleyan Station) but paying taxes only on the gains from Treaty Fields' sale of high-basis property (the Barnes & Noble Corner) supported an inference that OFI structured its transactions to avoid the purposes of Section 1031(f).

Further support for such inference was found in the unneeded complexity in the series of transactions. OFI could have achieved the same result by simply engaging in a direct exchange of property with Treaty Fields, and Treaty Fields could have then sold Wesleyan Station to the McEachern Family Trust. The Eleventh Circuit was not persuaded by OFI's assertion that the Barnes & Noble Corner property was merely a fallback position, and it had engaged in a complex series of transactions with the genuine desire to find a replacement property held by an unrelated third party. Not only did OFI examine just a small number of potential replacement properties but it also entered into a sales contract for the Barnes & Noble Corner property just six days after it engaged Security Bank as a QI. Moreover, OFI offered no explanation for maintaining a four-party transaction structure once it settled on the Barnes & Noble Corner property, given that the contract with the McEachern Family Trust for the sale of the Wesleyan Station had been fulfilled and the contract did not require OFI to structure the transaction as a like-kind exchange.

The Eleventh Circuit next rejected OFI's claims that tax-avoidance was not a principal purpose of its exchange, finding support in the following factors: (1) OFI and Treaty Fields cashed-in on their low-basis property but paid taxes as if they had cashed-in on their high-basis property; (2) OFI and Treaty Fields significantly reduced their immediate taxes by engaging in the exchange; and (3) OFI and Treaty Fields enhanced these immediate tax savings by shifting nearly the entire burden of taxation to the party with the lowest tax rate, Treaty Fields. OFI attempted to counter this evidence by arguing it believed adverse future tax consequences would outweigh any immediate tax savings from the exchange, but that, despite these adverse future tax consequences, it went ahead with the exchange for legitimate business reasons. Not persuaded that the Tax Court committed clear error, the Eleventh Circuit affirmed the Tax Court's conclusion that Section 1031(f)(4) disallowed nonrecognition treatment for OFI's exchange.

DEFAULT BY A QI

The paramount obligation of a QI in a Section 1031 transaction is to hold exchange funds during the exchange period and timely deliver them to acquire replacement property. If the QI fails to meet this fundamental duty for any reason, the exchanger's transaction will likely fail to achieve the deferral offered by Section 1031. More important, as some exchangers discovered in recent years, a QI's failure to adequately protect exchange funds can result in permanent loss of sale proceeds.

Because the exchange period may extend for a maximum of 180

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[13] The Tax Court also noted that the agreement to purchase the Barnes & Noble Corner was entered into six days after OFI sold Wesleyan Station to Security Bank in the exchange, which implied to the court that, on the date of the sale of Wesleyan Station, OFI already had "prearranged" to acquire replacement property from a related party.

days (except in the event of a presidentially declared disaster), any delay in completing acquisition of replacement property may make a valid Section 1031 exchange impossible to complete.

A QI may fail to meet its obligation to deliver exchange funds to a replacement property closing for a variety of reasons. The QI may have placed the exchange funds in an illiquid investment, which causes them to be unavailable at the appointed time. This is apparently what happened with LandAmerica 1031 Exchange Services, Inc., which disclosed in a letter to clients that it was unable to meet liquidity demands when it could not access funds invested in auction rate securities on the collapse of the auction market.[14] Many exchangers have assumed that their exchange funds are always placed in highly liquid, highly secure vehicles such as money market accounts. Virtually no state or federal regulation, however, governs how or where a QI is obligated to hold exchange funds.[15]

Similarly, exchange funds can be lost if they are simply misappropriated by an unscrupulous QI or diverted to fund other business activities of the QI or its owners.[16] Another incorrect assumption among exchangers is that QIs themselves, perhaps like other depository institutions, are state-chartered, highly regulated, or subject to licensure. In fact, until a very short time ago, the operations of QIs were largely unregulated.

During the last few years, several QIs failed spectacularly, including Southwest Exchange Corp., 1031 Tax Group, LLC, and LandAmerica Exchange Services.[17] Claims for more than $800 million of exchange funds were filed in various bankruptcy courts as a result of these failures. As noted above, in virtually all these cases the QI failure prevented taxpayers from completing pending deferred exchanges—very few taxpayers had the wherewithal to substitute outside funds for the exchange funds that were held captive by the defaulting QI (or its receiver, bankruptcy trustee, or other party in control of the QI's assets).

The question then became what happens in the event of such failure? In the normal case of a failed deferred exchange, the taxpayer is treated as having realized gain or loss in the year that the relinquished property was transferred, unless the exchange period extends to the following year and Reg. 1.1031(k)-1(j) allows the taxpayer to treat the transaction as an installment sale. If these rules applied, unfortunate taxpayers were faced with potential for gain recognition and tax liability in the year of their relinquished property transfers, with an uncertain future recovery of the exchange funds and potential for future offsetting loss reporting. This obviously was not a happy prospect for those affected.

Rev. Proc. 2010-14

The IRS recognized in Rev. Proc. 2010-14, 2010-12 IRB 456, that in some situations taxpayers who initiated like-kind exchanges by transferring relinquished property to a QI are unable to complete these exchanges within the exchange period due to the failure of the QI to acquire and transfer replacement property to the taxpayer. In many of these cases, the QI goes into bankruptcy or receivership, thus preventing the taxpayer who entered into the exchange in good faith from obtaining immediate access to the proceeds of the sale of the relinquished property. The Service stated in section 4.01 of the Procedure:

"If a QI defaults on its obligation to acquire and transfer replacement property to the taxpayer and becomes subject to a bankruptcy or receivership proceeding, the taxpayer generally may not seek to enforce its rights under the exchange agreement with the QI or otherwise access the sale proceeds from the relinquished property outside of the bankruptcy or receivership proceeding while the proceeding is pending. Consequently, the Service will treat the taxpayer as not having actual or constructive receipt of the proceeds during that period if the taxpayer reports gain in accordance with this revenue procedure."

Under section 3.01 of Rev. Proc. 2010-14, a taxpayer who satisfies four conditions is not required to recognize gain from a failed exchange until the tax year in which the taxpayer receives a payment attributable to the relinquished property. Specifically, for this rule to apply:

1. The taxpayer must have relinquished property to a QI in accordance with Reg. 1.1031(k)-1(g)(4).

2. The taxpayer must have properly identified replacement property within the identification period (unless the QI default occurred during that period).

3. The taxpayer did not complete the like-kind exchange solely because of a QI default involving a QI that became subject to a bankruptcy proceeding under the U.S. Code or a receivership proceeding under federal or state law.

4. The taxpayer did not, without regard to any actual or constructive receipt by the QI, have actual or constructive receipt of the proceeds from the disposition of the relinquished property or any property of the QI prior to the time the QI en-

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14 See, e.g., In re LandAmerica Financial Group, 412 Bkrptcy. Rptr. 800 (Bkrptcy. DC Va., 2009).

15 Changes are in the works, however. The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203, 7/21/10; the "Act"), which focuses on, inter alia, protecting consumers from abusive financial services practices, established the Bureau of Consumer Financial Protection, an independent part of the Federal Reserve System created to regulate the offering and provision of consumer financial products or services under federal consumer financial laws. Under section 1079 of the Act, the Director of the Bureau must submit to Congress by 7/21/12 a report describing (1) recommendations for legislation to ensure the appropriate protection of consumers who use exchange facilitators (the definition of which includes QIs) for transactions primarily for personal, family, or household purposes, (2) recommendations for updating the regulations of federal departments and agencies to ensure the appropriate protection of such consumers, and (3) recommendations for regulations to ensure the appropriate protection of such consumers. Not later than two years after the date of the submission of such report, the Bureau is required to propose regulations or otherwise establish a program to protect consumers who use exchange facilitators.

16 See, e.g., In re the 1031 Tax Group, LLC, 374 Bkrptcy. Rptr. 78 (Bkrptcy. DC N.Y., 2007).

17 See also notes 14 and 16, *supra*.

tered bankruptcy or receivership. For purposes of this fourth requirement, relief of a liability pursuant to the exchange agreement prior to the QI default, either through the assumption or satisfaction of the liability in connection with the transfer of the relinquished property or through the transfer of the relinquished property subject to the liability, is disregarded.

Section 4.02 of Rev. Proc. 2010-14 provides that a taxpayer who satisfies these requirements may report gain realized on the disposition of the relinquished property as the taxpayer receives payments attributable to the relinquished property, using the safe harbor gross profit ratio method described in section 4.03. Under this method, the portion of any "payment attributable to the relinquished property" is determined by multiplying the payment by a fraction (the "gross profit ratio") in which the numerator is the taxpayer's "gross profit" and the denominator is the taxpayer's "contract price." Three definitions are key to understanding the application of this method.

Payment attributable to the relinquished property. First, a "payment attributable to the relinquished property" means a payment of proceeds, damages, or other amounts attributable to the disposition of the relinquished property (other than selling expenses), whether paid by the QI, the bankruptcy or receivership estate of the QI, the QI's insurer or bonding company, or any other person. Unless debt exceeded adjusted basis (as discussed below), satisfied indebtedness is not a payment attributable to the relinquished property.[18]

Gross profit. Second, "gross profit" means the selling price of the relinquished property, minus the taxpayer's adjusted basis in the relinquished property (increased by any selling expenses not paid by the QI using proceeds from the sale of the relinquished property).[19] For purposes of applying this rule, the selling price of the relinquished property is generally the amount realized on the sale of the relinquished property, without reduction for selling expenses.

If, however, a court order, confirmed bankruptcy plan, or written notice from the trustee or receiver specifies, by the end of the first tax year in which the taxpayer receives a payment attributable to the relinquished property, an amount to be received by the taxpayer in full satisfaction of the taxpayer's claim, the selling price of the relinquished property is the sum of the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis) received or to be received and the amount of any satisfied indebtedness not in excess of the adjusted basis of the relinquished property.[20]

Contract price. Third, the "contract price" is the selling price of the relinquished property minus the amount of any satisfied indebtedness not in excess of the adjusted basis of the relinquished property.[21] For purposes of applying this rule, "satisfied indebtedness" means any mortgage or encumbrance on the relinquished property that was assumed or taken subject to by the buyer or satisfied in connection with the transfer of the relinquished property.[22]

A special rule applies where satisfied indebtedness exceeded the adjusted basis of the relinquished property.[23] In this situation, the amount of satisfied indebtedness in excess of the adjusted basis of the relinquished property is treated as a payment attributable to the relinquished property in the year in which the indebtedness is satisfied.

Gain recognition. Although section 4.01 generally provides for the deferral of gain recognition, any required depreciation recapture is taken into account under Sections 1245 and 1250. The recapture income, however, is included in income in the tax year in which gain is recognized only to the extent of the gain recognized in that year.[24] Thus, recapture is limited as to both amount and timing by the general rule in section 4.01.

The total gain recognized by the taxpayer under Rev. Proc. 2010-14 (including recapture income) does not exceed the sum of (1) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis) and (2) the satisfied indebtedness not in excess of basis, minus (3) the adjusted basis of the relinquished property and (4) selling expenses. Adjustments to the gain determined using the safe harbor gross profit ratio are made in the last tax year in which the taxpayers receive a payment attributable to the relinquished property.[25]

Losses. The Service recognized in Rev. Proc. 2010-14 that taxpayers could recognize a loss as a result of a QI default. Under section 4.08, a taxpayer within the scope of the Procedure may claim a loss deduction under Section 165 for the amount, if any, by which the adjusted basis of the relinquished property exceeds the sum of (1) the payments attributable to the relinquished property (including satisfied indebtedness in excess of basis)[26] plus (2) the amount of any satisfied indebtedness not in excess of basis. A taxpayer entitled to claim a loss deduction under this provision also may claim a loss deduction under Section 165 for any gain recognized in accordance with section 4 of Rev. Proc. 2010-14 in a prior tax year. The timing and character of any loss claimed by the taxpayer is determined under the general rules of the Code.[27]

Imputed interest. Since Rev. Proc. 2010-14 essentially adopts installment sale principles for exchanges that fail due to QI default, the IRS

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18 Rev. Proc. 2010-14, 2010-12 IRB 456, section 4.04(1).

19 *Id.*, section 4.04(2).

20 *Id.*, section 4.04(3).

21 *Id.*, section 4.04(4).

22 *Id.*, section 4.05.

23 *Id.*

24 *Id.*, section 4.06.

25 *Id.*, section 4.08.

26 The reference to "satisfied indebtedness in excess of basis" does not make sense because section 4.04(8) applies only if payments, including satisfied indebtedness, are less than the adjusted basis of the relinquished property.

27 Rev. Proc. 2010-14, section 4.08.

also addressed imputed interest. For purposes of applying the safe harbor gross profit ratio method to a transaction, the selling price, the contract price, and any payment attributable to the relinquished property must be reduced by the amount of any imputed interest allocable to the payment as determined under Section 483 or 1274, whichever applies.[28]

For purposes of applying Section 483 or 1274 to a transaction, the taxpayer is treated as selling the relinquished property on the date of the confirmation of the bankruptcy plan or other court order that resolves the taxpayer's claim against the QI (the "safe harbor sale date"), rather than on the date the relinquished property was actually sold to a buyer and exchange funds were deposited with the QI. As a result, if the only payment in full satisfaction of the taxpayer's claim is received by the taxpayer by the date that is six months after the safe harbor sale date, then no interest will be imputed on this payment under either Section 483 or 1274.

In addition, the selling price determined under section 4.04(3) is used to determine whether Section 483 (in general, sales for $250,000 or less) or Section 1274 (in general, sales for more than $250,000) applies.[29]

Exchange facilitator loans. Another problem addressed in Rev. Proc. 2010-14 arises in situations in which the exchange funds held by the QI were treated as an "exchange facilitator loan" under Reg. 1.468B-6(c)(1). Under that provision, exchange funds held by the QI are generally treated as loaned from a taxpayer to the QI, and the QI must take into account all items of income, deduction, and credit attributable to the exchange funds, although the exchange agreement can provide that all the earnings attributable to the account are taxable to the taxpayer in certain situations.[30] The exchange facilitator loan is then subject to special rules in Reg. 1.7872-16 in order to determine whether it bears adequate stated interest, or, alternatively, whether interest will be imputed to be paid by the QI and earned by the taxpayer.

Section 4.09(2) of Rev. Proc. 2010-14 provides that in situations involving exchange facilitator loans that meet the requirements of Reg. 1.7872-5(b)(16), the IRS will continue to treat the loan as meeting the requirements of that provision until the safe harbor due date, even if the duration of the loan exceeds six months solely due to the QI default. Furthermore, if an exchange facilitator loan does not meet these requirements because the loan exceeds $2 million, the Service will not impute additional interest on the loan under Section 7872 after the date of the QI default. Interest may be imputed under Section 483 or 1274, however, as provided in section 4.09(1).[31]

Rev. Proc. 2010-14 applies to taxpayers whose like-kind exchanges fail due to a QI default occurring after 2008. A taxpayer who is within the Procedure's scope may, subject to the limitations on credit or refund under Section 6511, file an original or amended return to report a deferred like-kind exchange that failed due to a QI default in a tax year ending before 2009, in accordance with Rev. Proc. 2010-14.[32] In other words, the Revenue Procedure effectively applies to all open tax years.

Analysis. The most important aspect of Rev. Proc. 2010-14 is that when a QI defaults, taxpayers who sold relinquished property pursuant to a deferred exchange agreement are not required to recognize the entire realized gain in the year of the sale. Before the issuance of this Procedure, there was considerable concern that the taxpayer could be deemed to be in constructive receipt of the amounts received by the QI, and there would be no nonrecognition under Section 1031 because the taxpayer never completed a like-kind exchange.

Furthermore, by adopting a modified installment sale approach in Rev. Proc. 2010-14, the Service has appropriately recognized that a taxpayer's gain should be based on amounts actually received plus the amount of any debt satisfied. By allowing taxpayers to first use their basis to offset any debt assumed or satisfied on transfer of relinquished property, Rev. Proc. 2010-14 reaches a result that will be favorable in most situations. (The IRS could have instead required the basis to be applied pro rata against all payments rather than first against any indebtedness assumed or satisfied, which would have had the effect of accelerating gain recognition.)

Nevertheless, there are several issues that taxpayers should be aware of.

Failure due "solely" to QI default. In order to apply, Rev. Proc. 2010-14 requires that a taxpayer's failure to complete an exchange must be due "solely" to a QI default. It is not clear how literally this language will be applied, or what burden of proof will be placed on taxpayers to demonstrate that the condition has been satisfied.

In many instances, deferred exchanges that are commenced by taxpayers are not completed because the taxpayers decide against acquiring properties properly identified as potential replacement properties or because the identified properties prove impractical or impossible to acquire despite taxpayer efforts. This might occur where a taxpayer is unable to secure mortgage financing sufficient to acquire a specific replacement property.

Where a QI default occurs during the taxpayer's exchange period but after a decision has been made not to complete the exchange, may Rev. Proc. 2010-14 still apply? Reading the Procedure literally, this does not seem likely. If this is the case, what certification will taxpayers be asked to make in order to show that they satisfy the condition?

The same question can be asked about exchanges that fail due to taxpayers' failure to satisfy either the "qualified use" or like-kind standards under Section 1031. For example, what if the relinquished property was personally used by a taxpayer to the

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28 *Id.*, section 4.09(1).
29 *Id.*
30 Reg. 1.468B-6(c)(2).
31 Rev. Proc. 2010-14, section 4.09(2).
32 *Id.*, section 5.

extent that it was not held for use in a trade or business or for investment?[33] In such circumstances, it does not seem that the QI default is the cause of the attempted exchange's failure or that the relief offered by Rev. Proc. 2010-14 will be available.

What about reverse exchanges? Rev. Proc. 2010-14 applies only to deferred exchanges and not, by its literal terms, to reverse exchanges under Rev. Proc. 2000-37. A reverse exchange can be structured as either an exchange-first or an exchange-last transaction, as discussed above.

If the EAT enters into bankruptcy in an exchange-first transaction, it would seem that the taxpayer would be concerned because the timing requirements for the reverse exchange would not be satisfied; the EAT would not be able to sell the relinquished property on a timely basis. The same concerns would arise in an exchange-last transaction in which the taxpayer would not be able to timely acquire the replacement property from an EAT that had filed for bankruptcy.

The Service may want to consider whether relief similar to that in Rev. Proc. 2010-14 should be provided to taxpayers who engage in reverse exchanges. Indeed, the IRS might have more flexibility in this regard because the requirements for reverse exchanges are not specified in Section 1031, so that the Service could relax the safe harbor time periods that are of its own making.

Imputing interest. The Service's insistence in Rev. Proc. 2010-14 that the imputed interest rules in Sections 483 and 1274 apply to payments may be theoretically correct, but it seems somewhat harsh. Most taxpayers whose QIs have defaulted will be receiving substantially less money than they had originally contracted to receive from the purchaser.

The IRS was somewhat helpful by providing that interest runs only from the date that the bankruptcy plan is finalized. Nevertheless, it would have been even better if the Service would have provided that no interest is imputed at all or, alternatively, that interest is imputed only to the extent that the total amount received exceeds the taxpayer's adjusted basis in the property (i.e., imputing interest on the gain element, if any, in the transaction).

For example, if a taxpayer with an adjusted basis of $100 in the relinquished property receives a payment of $70 more than one year after the bankruptcy plan is finalized, and assuming that the imputed interest is $5, the taxpayer would have an economic loss of $30 but report a tax loss of $35 ($100 basis less $65 imputed principal payment) and $5 of interest income. Depending on the character of the loss, the taxpayer might not be able to offset the interest income with the extra $5 loss, which would undoubtedly be viewed by the taxpayer as rubbing salt in its wounds.

QI default without bankruptcy. Rev. Proc. 2010-14 applies if a QI files for bankruptcy or enters into a receivership, but it does not apply if the QI simply defaults on its obligations. This would give potential leverage to a QI that has "evil intent" and wants to negotiate more favorable terms from its counterparties; the QI could simply threaten to default (and not file for bankruptcy) unless its counterparties agree to make payments to it. The IRS could have extended Rev. Proc. 2010-14 to address QI defaults as well as bankruptcy and similar proceedings.

Full satisfaction vs. contingencies. The "full satisfaction" requirement in section 4.04(3) appears to be inappropriate if additional payments are contingent. This often is the case in a bankruptcy proceeding. Bankruptcy judges need to have the flexibility to provide for contingent payments over time; the adverse tax consequences to the taxpayers whose money was tied up by the bankruptcy proceeding may provide an inappropriate incentive to limit any contingent payments to taxpayers (to their overall financial detriment).

Timing questions. Another problem involves the timing of gain and loss. In section 4.08, Rev. Proc. 2010-14 clearly allows a loss to be recognized when a gain arising from the exchange was recognized in a prior year due to basis recovery timing rules. Nevertheless, this rule does not explicitly state that a loss in a subsequent year can offset other gain, including gain that could arise from the receipt of boot (in the form of cash or failure to replace all of the debt that encumbered the relinquished property).

It would seem appropriate that the transaction should be viewed as a whole in order to determine whether the taxpayer should recognize gain or loss. Indeed, one of the problems with Rev. Proc. 2010-14 is the Service's insistence that the tax consequences of a QI bankruptcy be considered on a year-by-year basis, when it might be better to view the exchange transaction as remaining "open" until the bankruptcy is resolved.

Comments. In addition to promulgating rules relating to the exchanges that fail due to QI default, the IRS in Rev. Proc. 2010-14 solicited comments about whether additional guidance would be appropriate. One specific question for which comments were requested concerned the provisions in the Regulations (permitting the use of qualified escrows and qualified trusts) that allow proceeds from the disposition of relinquished property to be held in such a way that they do not become property of the QI's bankruptcy estate. The Service sought comments as to whether these techniques should be available for use in a more efficient manner.

This request for comments points up one of the most important aspects of Rev. Proc. 2010-14, which is its recognition that a taxpayer could have avoided an economic loss if it had used a qualified trust under Reg. 1.1031(k)-1(g)(3) in conjunction with a QI (under Reg. 1.1031(k)-1(g)(4)) in its exchange. Although a qualified trust usually costs more to implement than an exchange with a QI, the fact that a loss would be

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[33] See, e.g., Moore, TCM 2007-134.

avoided as a result of a bankruptcy filing by the QI likely makes this upfront cost well worth incurring.

UNDERWATER LIKE-KIND EXCHANGES

Not only have taxpayers had to deal with QI failures in recent years, but property values significantly dropped in light of the economic downturn. Property that is encumbered by debt in an amount exceeding the FMV of the property is said to be "underwater." Even where this is the case, taxpayers may be able to take advantage of Section 1031 to defer gain recognition in the event of a foreclosure.

A Typical Underwater Situation

Assume that Rachel acquired a residential rental property for $1 million in 2001. She used $100,000 of her own funds for equity, and borrowed $900,000 on a nonrecourse basis, with the property serving as the sole collateral for the loan. The lender insisted that Rachel hold title to the property through a bankruptcy-remote single-purpose entity, so she formed an SMLLC ("Propco") to hold the property.

Rachel claimed total depreciation of $300,000 during the past ten years, so her current tax basis in the property is $700,000. Rachel has paid only $50,000 of principal on the loan, so the debt that encumbers the property is now $850,000.

Rachel's problem is that due to market declines, the FMV of her property is now only $600,000. Therefore, the property is under water by $250,000. She does not believe that the value of the property will likely recover quickly enough to ever repay the lender, so she is thinking of simply relinquishing title to the lender.

To make matters a little more complicated, the relationship between Rachel and her lender is cloudy. She had borrowed from one of the numerous banks that disappeared during the financial crisis in 2008, and she believes that the loan was syndicated and is now being handled by a special servicer located in a city far away. She has spoken to the special servicer several times, but it is not clear whether or not the special servicer will cooperate.

Although the loan is a nonrecourse obligation, Rachel knows that the note contains "nonrecourse carveouts" (also referred to as "bad boy" clauses), under which she could have personal liability if certain things occur. One of the nonrecourse carveouts would trigger full recourse liability to Rachel if Propco were to file a voluntary petition in bankruptcy. The loan also provides that failure to pay local property taxes is a nonrecourse carveout, although the loan documents are not completely clear whether there would be a violation of this provision if the property failed to generate sufficient gross revenue to pay the real estate taxes.

At this time, all of the gross rent from the property is transferred directly to a lock box for the benefit of the lender, which pays debt service and real property taxes from the funds available. Although the real property taxes have been covered to date, Rachel is worried that the loss of tenants due to increased local unemployment may in the future result in rental income that is less than the sum of the debt service plus real property taxes related to the property.

Rachel's tax advisor has explained that a simple foreclosure will result in $150,000 of gain, because the basis in the property is $700,000 while the debt is $850,000. Furthermore, this gain will be taxable at a 25% rate because of depreciation recapture. When state and local taxes are taken into account, Rachel would likely have to come out of pocket for $60,000 to satisfy the tax bill related to a foreclosure on her property.

Rachel's tax advisor pointed out one other important issue for her to consider, which is whether the debt is a recourse or a nonrecourse obligation. If a borrower conveys property to a lender in satisfaction of a nonrecourse obligation, the transaction is treated as a sale or exchange in which the taxpayer is treated as having sold the property for an amount equal to the indebtedness. In Rachel's case, that would result in gain of $150,000, as noted above.

If the obligation is a recourse liability, however, the taxpayer is treated as (1) exchanging property with a value equal to the FMV of the property for an equal amount of the obligation, and (2) benefiting from the cancellation of the balance of the debt. In Rachel's case, this would result in a sale of the property for a loss of $100,000 (FMV of $600,000, basis of $700,000) and $250,000 of COD income ($850,000 of debt vs. $600,000 FMV). This would not be conducive to a like-kind exchange.

This difference in treatment leads to a threshold question, which is whether nonrecourse carveouts cause an obligation to be treated as a recourse liability. Although there is no clear law on this issue, the better view is probably that a nonrecourse carveout is a contingent obligation that should not be treated as a liability unless and until the predicate events have occurred, i.e., the borrower has taken an action giving rise to a recourse liability to the borrower. Therefore, a nonrecourse debt should not be converted into a recourse liability unless the lender has successfully made a claim against the taxpayer pursuant to the nonrecourse carveouts. In Rachel's case, where no such claim has been filed (and where, as of the date of the conveyance of the property to the lender, there was no basis for such a claim), the obligation should be treated as a nonrecourse debt, so that a conveyance of the property to the lender could give rise to an exchange.

This answer leads to the second threshold question, which is whether an underwater property can be the subject of a like-kind exchange, because the borrower has no equity in the property. Again, there is no clear law on the topic, but it seems that the better view is that the "phantom gain" that arises from a foreclosure qualifies for nonrecognition under Section 1031 just as any other gain from the conveyance of property.

Under *Tufts*, 461 U.S. 300, 51 AFTR2d 83-1132 (1983), the conveyance of property to the lender is a sale or exchange of the property, and Section 1031 does not require that the taxpayer have equity in the prop-

erty—it requires only a sale or exchange. Furthermore, the IRS has taken the position that Section 1031 applies when property is sold at either a gain or a loss, implying that the key element in the application of Section 1031 is the sale or exchange and not the amount of the proceeds from the sale.

Further support for this view is found in Section 1031(d), which states that the assumption of a liability in connection with an exchange constitutes part of the consideration to the taxpayer resulting from the exchange. This provision does not state that additional consideration must be provided, so it seems logical that the transfer of property in satisfaction of a liability would be an exchange for purposes of Section 1031, even if there were no other consideration provided to the taxpayer in connection with a foreclosure on her property.

Nonetheless, it is not completely clear that an exchange of underwater property qualifies for nonrecognition under Section 1031. It is possible that the IRS will take the position that a taxpayer cannot exchange property which has no equity. The Service could possibly support this view by making an analogy to Section 357(d), which limits the amount of debt taken into account on a transfer of property to a corporation to the FMV of the property. Similarly, Reg. 1.368-1(f) limits debt to the FMV of property in a reorganization.

The Tax Court did not agree with IRS that an accidental transfer followed by an immediate return of funds constituted actual or constructive receipt.

These analogies notwithstanding, the better view seems to be that a taxpayer can engage in an exchange involving underwater property, provided that the requirements of Section 1031 are otherwise satisfied.

If, however, the transaction will involve a QI, it still is necessary for the taxpayer to satisfy the requirements of the QI safe harbor relating to the QI's role as an exchange counterparty in order for Section 1031 to apply. Thus, the taxpayer who owns the underwater property must either transfer title to the underwater property to the QI or, alternatively, assign the transfer agreement to the QI.

A Friendly Lender

Notwithstanding that the law does not seem to require Rachel to have any equity in her property in order to complete a like-kind exchange in a foreclosure context, if Rachel is very conservative she will want to receive consideration from the lender as part of the transaction. For example, Rachel could transfer the property to the lender as part of a transaction in which:

1. Rachel enters into a deed in lieu of foreclosure ("deed-in-lieu") agreement with the lender,
2. She assigns her obligations under such agreement to a QI,
3. She transfers the property to the lender directly in satisfaction of her obligation, and
4. The lender conveys a small amount of consideration (say, $1,000) to the QI in consideration for Rachel's transfer of the property to the lender.

Why would the lender be willing to give a small amount of money to Rachel when the property is under water? The lender may have concluded that it would save substantially more money by having a cooperative borrower rather than a contentious one. Or the lender may have concluded that it has some potential exposure in connection with the underwriting and issuance of the loan, so that a friendly foreclosure is in the lender's best interest. Or the lender may just have decided that a payment that avoids a long, drawn-out foreclosure process is worthwhile. In any event, experience has shown that some lenders are willing to pay a small amount of consideration in order to induce a borrower to engage in a deed-in-lieu transaction.

For purposes of a Section 1031 exchange, this is the best possible alternative, because the taxpayer would have an agreement that she could assign to the QI, and the QI would receive consideration from the "buyer" of the property, i.e., the lender. Although the transfer is taking place in the foreclosure context, it still would constitute a willing exchange between a buyer (the lender) and a seller (the borrower). Thus, it appears that as long as the taxpayer receives any consideration from the lender and otherwise follows the form of a like-kind exchange by entering into the appropriate agreements with a QI who participates in the exchange, the IRS would not have a decent argument that the transfer did not satisfy the requirements of Section 1031.

The taxpayer also would have to timely acquire replacement property. In Rachel's case, assuming that the lender was willing to give her $1,000 of cash to engage in a deed-in-lieu transaction, she still would need to buy a replacement property costing at least $851,000 to avoid gain on the exchange (in the exchange, Rachel received consideration equal to the debt of $850,000 plus $1,000 in cash). It is clear that Rachel can use new equity in acquiring a replacement property to replace the debt that encumbered the relinquished property, but Rachel still would have to come up with a lot of money to do so. If the replacement property is not encumbered, this could be difficult to accomplish.

Rachel also could acquire a property with moderate leverage, e.g., she could buy a property costing $851,000 using $600,000 of new debt plus $251,000 of equity. The problem, of course, is that this transaction would require Rachel to come up with $250,000 of new money to avoid paying a current tax of approximately $60,000. Many taxpayers would avoid this economic tradeoff.

Suppose Rachel had acquired the relinquished property through a prior like-kind exchange, so that her basis in the relinquished property were lower—say, $200,000 instead of $700,000. Now, she would be staring at gain of $650,000 on the foreclosure. In that event, instead of paying a tax bill in excess of $200,000, Rachel might consider it worthwhile to ac-

quire a replacement property using a significant amount of new equity.

Zero-cash-flow replacement property. It also is possible that Rachel would be able to use the $1,000 received from the lender, together with a small amount of additional equity, to acquire a so-called "zero-cash-flow" property. Property that is subject to a triple-net lease to a creditworthy tenant sometimes will be sold subject to a loan that consumes all of the cash flow from the property. Because of the secure nature of the cash flow, plus the fact that nothing is paid to the borrower until the debt is repaid in full, lenders frequently will lend a much higher percentage of the FMV of the property in such transactions.

In that situation, the owner of the property (Rachel) will not receive any cash flow from the property, because all of the cash will be used for debt service. For purposes of completing a like-kind exchange, however, the entire debt that encumbers the property will be treated as part of the consideration paid for the property.

If Rachel acquires a zero-cash-flow property, she should be aware that the transaction will not permanently defer gain recognition—the deferred gain would be recognized as the debt is amortized from cash flow. In other words, the taxable gain deferred through the acquisition of a zero-cash-flow property will be effectively "recaptured" as principal is paid on the debt. (The taxpayer will have taxable income as rent is used to pay principal on the debt, but unless the taxpayer has depreciation or other non-cash deductions, the taxpayer will not be able to offset this taxable income. As a practical matter, assuming the taxpayer had a low basis in the relinquished property, the taxpayer will suffer recapture as the principal on the debt is repaid.)

The taxpayer can avoid this result only by virtue of the basis step-up that occurs on death. There will be no immediate tax consequences to Rachel, however, assuming that the debt on the replacement property is as large (or larger) than the liability that encumbered the relinquished property.

Other possibilities. Rachel also may want to consider alternative ways to acquire a replacement property. In addition to a traditional purchase, Rachel might want to consider acquiring a note that encumbers the property that Rachel wants. The problem, of course, is that the note itself does not constitute a suitable replacement property for purposes of a like-kind exchange under Section 1031(a)(2)(C). Instead of directly acquiring the note, however, Rachel could provide funds to the QI; the QI could acquire the note for Rachel's benefit. The QI then would foreclose on the note and obtain direct ownership of the property, which would be conveyed to Rachel to complete the exchange.

In some situations, the taxpayer already may own a note that encumbers property that the taxpayer thinks would make a suitable replacement property. In that event, the taxpayer has two options:

1. The taxpayer could assign the note to the QI and have the QI acquire the note as a replacement property. Since the QI and the taxpayer are not related, this transaction should not run afoul of Section 1031(f).

2. Instead, the taxpayer simply may want to engage in a reverse exchange, using an EAT to acquire the property by foreclosure on the note. Rev. Proc. 2004-51, 2004-2 CB 294, prohibits a taxpayer from using a reverse exchange to acquire a replacement property in which the taxpayer had an interest during the preceding six months.[34] This rule would not be applicable in this situation, however, because the taxpayer owned only a note and not the property during that period. Therefore, a taxpayer who owns an underwater property that may be subject to foreclosure may want to consider acquiring the note that encumbers another property as a potential replacement property for the underwater asset.

A Moderately Friendly Lender

What if the lender is not willing to make any payment to Rachel?

In that event, Rachel still should be comfortable engaging in a deed-in-lieu transaction with the lender in which she enters into an agreement providing for the conveyance of the property to the lender. This deed-in-lieu agreement can be assigned to the QI, and the QI can then use funds received from Rachel to acquire replacement property from a third party. Assuming that a replacement property cannot be acquired subject to 100% leverage, the amount of the new equity that Rachel will have to contribute will increase, but this should not be a significant change given the small amount of consideration that would have been received from a friendly lender in any event. The "friendly lender" transaction in which the lender makes a payment to the borrower is preferable, of course, because there is consideration received by the QI from the lender directly, but the risk in the "moderately friendly" scenario appears to be quite low.

The practical implication of these two alternatives is that a deed in lieu of foreclosure is the best scenario for a taxpayer who wants to use Section 1031 to avoid gain recognition as a result of the foreclosure on a relinquished property. A deed-in-lieu is a "voluntary" transaction in which it is easy to see that an exchange has occurred. Furthermore, there usually will be a deed-in-lieu agreement that can be assigned by the taxpayer to a QI as part of the exchange. Thus, the risk to the taxpayer in such a transaction, if it is properly implemented, appears to be quite low.

An Unfriendly Lender

What if the lender is not willing to enter into a deed-in-lieu agreement? Some lenders, particularly special servicers who have no relationship with the borrower, will not engage in any negotiations with the bor-

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

rower and will not consider entering into a deed-in-lieu agreement. These lenders will simply want to foreclose by auctioning the property off to the highest bidder. Usually the lender will be the highest bidder in a foreclosure sale by bidding in the debt. In that situation, our borrower still has some options.

Rachel still may be able to engage in a like-kind exchange by entering into an exchange agreement with a QI and assigning either the property or the interests in Propco to the QI. Ideally, Rachel simply would convey the property (subject to the debt that encumbers it) to the QI, and the QI could then allow the foreclosure to occur. From Rachel's perspective, this transaction would be treated as a sale of the property for an amount equal to the debt. Rachel could then acquire a replacement property (through the QI) with a purchase price at least equal to the amount of the debt that encumbered the relinquished property. As discussed above, Rachel would need to either contribute equity into the exchange, although the amount of equity could be decreased if Rachel can locate a zero-cash-flow property.

It is possible, however, that Rachel will not be able to transfer the property to the QI directly because the loan contains a non-assignment clause that would prevent her from transferring "clean title" to the property to the QI. In that event, Rachel needs to determine whether the loan agreement also contains a prohibition against the transfer of the interests in Propco, the SMLLC that owns the property.

Rachel may be able to convey all of the interests in Propco to the QI as the first step in the like-kind exchange. Assuming that Propco is a disregarded entity, the transaction would be treated as a conveyance of the property held by Propco for purposes of Section 1031. As a result, Rachel would again simply need to acquire a replacement property through an exchange involving the QI.

Nevertheless, it might be that Rachel will not be able to transfer to the QI either the property itself or the interests in the SMLLC that owns the property because of the nonrecourse carveouts that are associated with the loan. As discussed above, violation of the nonrecourse carveouts is a "worst case" scenario for the borrower, because it gives rise to a personal recourse obligation and makes it difficult to engage in a like-kind exchange (by potentially converting the debt from a nonrecourse obligation into a recourse one). Therefore, before engaging in any transaction involving property encumbered by a loan from an unfriendly lender, the borrower must first check to make certain that the borrower's actions will not give rise to a recourse obligation.

Abandonment. If a direct conveyance of either the property or the SMLLC that owns the property to a QI is not possible, there is one other alternative that could be pursued by the borrower—an abandonment of the property. In Rev. Rul. 93-80, 1993-2 CB 239, the IRS concluded that an abandonment of a property that is subject to a liability is treated as a sale or exchange. As a result, if a taxpayer can abandon a property that is subject to debt, the taxpayer will have undertaken the first step in a transaction qualifying under Section 1031.[35]

The problem that must be considered by the taxpayer who needs to abandon a property, however, is that an exchange requires two parties, and the noncooperating lender is unlikely to be willing to convey a replacement property to a taxpayer who has abandoned the property. Therefore, the taxpayer needs to find a counterparty with which an exchange can be arranged, i.e., the taxpayer needs to convey the relinquished property to a person and receive the replacement property from the same person. The question is whether a QI could fulfill this role.

For example, assuming that Rachel's lender is uncooperative, Rachel would need to find a way to abandon her property to the QI. Assuming that the loan agreement prohibits the transfer of either title to the property or the ownership interests in Propco to the lender, Rachel still could consider entering into a transaction in which she transfers the benefits and burdens of ownership (but not legal title) to the property to a QI through an assignment agreement between Rachel and the QI. The problem is that this approach does not appear to satisfy the technical requirements of Reg. 1.1031(k)-4(g)(4), which requires that legal title must be transferred to the QI to qualify for safe harbor treatment.

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35 See Lipton, "How to Avoid Capital Loss Treatment on the Abandonment of a Partnership Interest," 80 JTAX 158 (March 1994). Several decisions addressed the abandonment of a partnership interest. See Pickron, "Some Partners Will Find That Abandonment of Partnership Interests Accelerates Gain," 77 JTAX 268 (November 1992).

In Echols, 93 TC 553 (1989), *rev'd* 935 F.2d 703, 68 AFTR2d 91-5157 (CA-5, 1991), the taxpayer started out as a 37.5% partner in a partnership that owned undeveloped real property purchased in anticipation of an adjacent highway project. Another partner subsequently transferred an additional 37.5% interest to the taxpayer, so that the taxpayer owned 75% of the partnership. The taxpayer and the remaining 25% partner first attempted to sell the real estate. When that effort was not successful, the taxpayer met with the other partner and informed him that the taxpayer would no longer pay his 75% portion of the mortgage and taxes on the property. The taxpayer also offered to convey his interest to anyone who would assume his portion of the partnership debt. The taxpayer did nothing more during that year and claimed a capital loss. The Tax Court concluded that the taxpayer failed to manifest abandonment and disallowed the loss. The court of appeals concluded, however, that the taxpayer's actions were sufficient to abandon his interest.

After Echols, abandonment of a partnership interest was again an issue in Citron, 97 TC 200 (1991). There, the taxpayer was one of the limited partners in a partnership formed to produce a movie. He personally borrowed money to finance his partnership contribution. Subsequently, the taxpayer was informed that the movie would have to be converted into an X-rated film in order for the partnership to recover more of its costs. The taxpayer was not interested in participating in the production of an X-rated movie, and he communicated to the general partner and other limited partners that he no longer had any interest in the partnership or the movie. The Service contended that the taxpayer's communication with the general partner was not sufficient to be an abandonment of the taxpayer's partnership interest. In a reviewed opinion, the Tax Court disagreed, concluding that the taxpayer manifested his intent to abandon his partnership interest by an overt act of abandonment to the parties in interest (the general partner and all limited partners).

An argument could be made that a formal transfer of title to the property is not required in order to satisfy this safe harbor. As noted above, it is widely accepted that in lieu of transferring legal title to a property to a QI in an exchange, the taxpayer can transfer all of the ownership interests in an SMLLC that owns the property. These transfers are respected for purposes of the QI safe harbor because the QI has all of the benefits and burdens of ownership of the property, even if legal title has not been transferred. By analogy, if a transfer of the benefits and burdens of ownership is sufficient when the ownership interests in a QI are transferred, similarly an assignment of the benefits and burdens of ownership of the property could qualify in an underwater exchange.

This approach is arguably consistent with the Service's treatment of an abandonment, which is treated as an exchange under Rev. Rul. 93-80. If there is a sale or exchange, it must be a sale or exchange with someone. If a taxpayer can assign the benefits and burdens of ownership of an entity that owns property to a QI, and the QI then abandons the property to the lender, the taxpayer can contend that there was an exchange with the QI; the QI could then be used to acquire replacement property for the taxpayer.

In this transaction, it is important for the taxpayer to engage in an exchange with the QI. For example, Rachel could assign the benefits and burdens of the ownership of Propco to the QI, and the QI would then notify the lender that the QI was abandoning the property. (Simultaneously, Rachel would notify the lender of abandonment and abandon her bare legal title to Propco.)

The issue that this transaction will raise for Rachel is whether there has been a transfer to the QI that satisfies Reg. 1.1031(k)-1(g)(4)(v). The answer to this question is not clear under current law. Since the transfer of the benefits and burdens of the ownership of Propco normally will be treated for tax purposes as a transfer of Propco, and since the taxpayer will have no legal right to receive Propco back, the taxpayer can argue that there has been an exchange with the QI in which the economic equivalent of legal title to the property has been transferred to the QI. There are no authorities, however, that directly support this argument.

If the assignment of the benefits and burdens of the ownership of Propco does not satisfy the safe harbor, the next question is whether it is necessary to comply with the safe harbor in order to have a valid exchange. Usually, the QI is acting as the agent for the taxpayer, which is why the safe harbor must be complied with (because otherwise the receipt of cash by an agent would result in constructive receipt, which would spoil an exchange). If there is no cash being received by the QI, however, there cannot be constructive receipt by an agent.

Accordingly, a taxpayer who has abandoned property to a QI might take the position that an exchange through the QI should be respected even though the QI could be viewed as an agent of the taxpayer. The exchange could simply be seen as a deferred exchange entered into by the taxpayer, in which relinquished property is sold and replacement property is acquired by the taxpayer within the requisite 180 days, even though the QI is treated as the taxpayer's agent. In other words, the taxpayer (through its agent) directly sold the relinquished property and, within 180 days, the taxpayer (through its agent) acquired the replacement property—these are the only steps that the Code requires. Again, there are no authorities that directly support this argument, although a taxpayer could contend that the transaction is within the "spirit" of Section 1031.

There is no certainty that the IRS will agree with these interpretations of Section 1031 in the abandonment context. Indeed, there are no cases or rulings addressing how Section 1031 applies (if at all) to an abandonment, so Rachel would need to consider carefully the tax risk before entering into such a transaction. Nevertheless, in light of the Service's view that every abandonment of encumbered property is a sale or exchange, she may be able to argue that an abandonment of property to a QI can be treated as the first step in a deferred like-kind exchange.

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. There is still no definitive answer to this question, although your authors consistently have stated that there was no reason why a taxpayer could not encumber replacement property after an exchange. Indeed, your authors continue to subscribe to the theory under which a taxpayer can leverage the replacement property one nanosecond after it is acquired. Several practical points should be considered, however.

If a taxpayer intends to leverage replacement property immediately after an exchange, the taxpayer should make certain that the debt is in fact 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 requirements 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.

Some 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 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 relevant 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.

LIKE-KIND EXCHANGES INVOLVING PARTNERSHIPS

The partnership anti-abuse rule in Reg. 1.701-2 provides that the partnership rules of Subchapter K are intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of Subchapter K are the requirements, inter alia, that each partnership transaction or series of related transactions be entered into for a substantial business purpose and that the form of each partnership transaction be respected under substance over form principles.

In CCA 200919043, the taxpayer attempted to use a partnership in a Section 1031 exchange to get an artificial basis step-up in property. Although the facts were not disclosed, the Service recharacterized the series of transactions under the partnership anti-abuse rule to treat the taxpayer first as contributing real es-

tate to the partnership, and then as using cash to buy new real estate. The exchange as structured seemed "pre-wired," particularly given the fact that the taxpayer continued to own the original property and had acquired new property without any recognized gain.

Ownership of Relinquished Property

A frequently encountered problem in like-kind exchanges involves 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.

The most important aspect of the Procedure may be the flexibility that it gives to taxpayers and EATs in setting up the accommodation arrangement.

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. Because special allocations of cash and mortgage relief boot to certain partners in a partnership often will not be in accordance with the partners' interests in the partnership, special allocations are of limited use for partners looking to cash out of the partnership's ownership of relinquished property in a like-kind exchange.

Distribution of Undivided Interests

Assuming that gain cannot be specially allocated to the cash-out partners, many partnerships have distributed undivided tenancy-in-common (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. How did the property transfer relate to 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.

"Held for" test. 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 *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. Similarly, 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.

The problem with *Magneson* 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.

Does the partnership continue? 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).

Timing. 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, and under Section 732(b) their basis in the $5 million note should equal their outside basis of $5 million, resulting in no recognized gain as they receive payments. Correspondingly, JKLM's basis in the replacement property would be stepped down pursuant to Section 734(d).

If their outside basis was less than the principal amount of the note, Jack and Karen would recognize gain only as payments are received on the note.[36] 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 Buyout

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

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36 This gain could be entirely subject to classification as "unrecaptured Section 1250 gain," taxed at a 25% rate. This consequence must be considered when structuring installment note transactions, as described.

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 Service 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 briefly 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 Service 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) that was 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 private 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.

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. Notwithstanding, the California SBE recently decided two cases favoring the Service's position.

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.

Section 1031 was amended by DRA '84 to exclude partnership interests from qualifying as replacement or relinquished property in a like-kind exchange. As described in the Senate Report, 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."[37]

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 contribution 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."

Recent authority. 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

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

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).

Recently, the California SBE decided two notable, although noncitable, like-kind exchange cases involving "swap and drop" transactions. According to the SBE, the significance of these cases is that the Board sustained a taxable position where it recharacterized the taxpayer's transaction to reflect the realities of the transaction.[38]

The taxpayers in *Appeal of Frank and Mary Lou Aries,* Appeal No. 464475, were partners in a limited partnership that owned and operated apartments located in San Francisco. Under threat of eminent domain, the partnership sold the apartments to the City and County of San Francisco. The taxpayers elected to defer capital gain realized on the sale under Section 1033(a)(2). As one of its replacement properties, the partnership acquired an interest in rental real property located in Scottsdale, Arizona. The Scottsdale property was jointly purchased by the partnership and three other parties. Immediately after the purchase transaction, the purchasing parties contributed the Scottsdale property to a newly formed Arizona LLC, which engaged in the business of owning, leasing, operating and maintaining the property. In exchange for its interest in the property, the partnership received an interest in the Arizona LLC.

The California Franchise Tax Board (FTB) applied the step transaction doctrine and determined that the partnership's purchase of the interest in the Scottsdale property "was formulaic and transitory" and that the partnership entered into the transaction with the intention of acquiring a membership interest in the Arizona LLC. Accordingly, the FTB collapsed the steps taken and treated the transaction as if the partnership acquired a membership interest in the Arizona LLC, which did not qualify as replacement property under Sections 1031 and 1033.

The FTB cited *Sandoval,* TCM 2000-189, for the proposition that an exchange will not qualify for nonrecognition even if the replacement real property is acquired first, when there was a prior agreement to transfer the property to a partnership. In *Sandoval,* the Tax Court found that a group of taxpayers had agreed prior to the purchase of a replacement property to contribute the property to a partnership for business purposes. As a result, the Tax Court held that the taxpayers did not acquire qualifying replacement property for purposes of Section 1033.

The taxpayers in *Aries* argued that the interest in the Scottsdale property acquired by the partnership was qualified replacement property and that the conveyance of that interest to the Arizona LLC was not a disqualifying event. In support of their position, the taxpayers cited *Magneson,* contending that the FTB mischaracterized the transaction as an exchange of a partnership interest and that the partnership exchanged a fee interest in the apartments for an undivided interest in the Scottsdale property followed by a capital contribution to the Arizona LLC. The taxpayers further cited *Marks* to support the position that *Magneson* was not overruled by the enactment of Section 1031(a)(2)(D) in 1984.

By a 3-2 vote, the SBE sustained the FTB's determination that the taxpayers' "swap and drop" transaction did not qualify under Sections 1031 and 1033. Certain members of the SBE distinguished *Magneson* in that the court specifically limited its holding to circumstances where the acquired property was transferred into a partnership where the taxpayers were general partners; as general partners, the taxpayers maintained ownership and control of the property.[39] Conversely, the only right maintained by the taxpayers in *Aries* with respect to the Scottsdale property after it was contributed to the Arizona LLC was a veto power to prevent a sale.

In *Appeal of Gerald J. and Carol L. Marcil,* Appeal No. 458832, the husband and wife taxpayers were limited partners in a California limited partnership (HVA) formed to hold and manage certain real property located on North Vista in Los Angeles (the "Vista property"). The husband also owned a membership interest in an LLC (MD), formed to acquire and develop certain real property located on Manchester Boulevard in Los Angeles (the "Manchester property"). In 2001, HVA entered into an exchange agreement with a QI to sell the Vista property and acquire replacement property. The QI organized an SMLLC (Lava Rock) to acquire the Manchester property as the replacement property, which on acquisition was held 60% by Lava Rock and 40% by MD. Thereafter, the QI transferred to HVA its membership interest in Lava Rock, which HVA assigned to Gerald eight days later. Two weeks later, Gerald transferred the Lava Rock interest to MD. At the end of 2001, HVA filed a cer-

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38 California FTB Tax News, "Common Audit Issues and Recent Developments in the Like Kind Exchange Arena," page 6 (January 2012).

39 Transcript of Final Actions at 4-5, California SBE (10/19/10); Transcript of Final Actions at 5-6, California SBE (10/20/10).

tificate of dissolution with the California Secretary of State.

The FTB determined that HVA did not complete a like-kind exchange by acquiring the 60% interest in the Manchester property because it quickly distributed the property and terminated its legal existence.[40] For that reason, HVA failed to meet the "holding" requirement of Section 1031 and thereby effected a disqualifying swap and drop transaction. In their appeal to the SBE, the taxpayers cited *Bolker* and *Maloney* for the position that a swap and drop transaction qualifies under Section 1031. Conversely, the taxpayers argued that HVA continued to hold the Manchester property because a deemed merger occurred between HVA and MD when Gerald contributed his interest in Lava Rock to MD immediately after receiving it from HVA, in substance leaving HVA as the surviving partnership for tax purposes because its assets exceeded those of MD. By a 3-2 vote, the SBE denied the taxpayers' appeal.

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 and the California taxing authorities have not. Moreover, the Service's reasoning in its litigation-related Revenue 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 pre-1985 cases have been altered by the enactment of Section 1031(a)(2)(D), which provides that a partnership interest does not constitute replacement property. Like the FTB in *Aries*, 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 citable authorities squarely on point, the authors' 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.[41]

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 citable guidance on point, appropriate cautions should be voiced. Nevertheless, the weight of the law (and congressional intent) appears to support such transactions.

EXCHANGES OF INTANGIBLES AND BUSINESSES

Under Reg. 1.1031(a)-2(c), intangible personal property is of like-kind to other intangible personal property only if (1) the nature or character of the rights involved are of like-kind (e.g., a patent is of like-kind to a patent and a copyright is of like-kind to a copyright), and (2) the nature or character of the underlying property to which the intangible personal property relates is of like-kind. For example, an exchange of a copyright on a novel for a copyright on a different novel is a like-kind exchange, but an exchange of a copyright on a novel for a copyright on a song is not.

The IRS applied this two-part test in Ltr. Rul. 201024036. The taxpayer in that ruling exchanged governmental credits granting the right to emit a specified amount of air pollutants that create ground-level ozone (commonly known as smog). Specifically, nitrogen oxide ("NOx") credits were exchanged for volatile organic compounds ("VOCs") credits.

The Service found the nature and character of these rights to be the same because both were granted as part of a program to control air pollution and because both credits had identical terms and conditions. Further, the IRS found the nature and character of the underlying property to be the same because although NOx and VOCs are different chemical compounds, they are both ozone-causing pollutants, and controlling ozone is the primary purpose of the credits. As such, the differences between the two chemical compounds, insofar as they related to the credits and the purposes for issuing the credits, were regarded as differences in grade or quality (e.g., NOx credits were more valuable than VOCs credits because of their relative scarcity), which did not affect whether properties are of like-kind for purposes of Section 1031.

Further evidence that NOx and VOCs were of the same nature or character was found in the fact that under the program the NOx and VOCs credits were interchangeable under certain conditions and that both NOx and VOCs were emitted in the same process. Accordingly, the NOx credits and the VOCs credits were like-kind property eligible for nonrecognition treatment under Section 1031.

Past guidance from the Service involving exchanges of business intangibles was controversial. Many taxpayers questioned how Section 1031 applied in situations in which entire businesses were exchanged, including particularly businesses that own intangible assets such as

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40 The FTB and the taxpayers disagreed as to whether HVA transferred the Manchester property to MD or distributed the property to the husband.

41 See, e.g., Rev. Rul. 2001-24, 2001-1 CB 1290, and Rev. Rul. 2002-83, 2002-2 CB 927.

patents, trademarks and trade names, and goodwill. This question was addressed in TAM 200602034 and FAA 20074401F.

In TAM 200602034, 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 trade names, (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 trade names, (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 trade names 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.[42] 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.[43] 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.

Practice Notes

In a properly structured transaction where some partners want to exchange and some want to cash out of their investment, 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.

In exchanges of intangible property, the Service has adopted an even more rigorous test. As described above, 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 trade names should be treated as like-kind property. The IRS viewed trademarks and trade names 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.

In FAA 20074401F, the IRS had analyzed an exchange of newspaper businesses through a QI. The memorandum concluded that mastheads, advertiser accounts, and subscriber accounts of each newspaper were not like-kind property because they were "so closely related to (if not a

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

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

part of) the goodwill and going concern value." Consistent with prior private rulings, the memorandum reiterated the Service's expansive view of Reg. 1.1031(a)-2(c)(2) (goodwill or going-concern value of an exchanged business can never be like-kind property). The memorandum dismissed the taxpayer's reliance on *Newark Morning Ledger Co.*, 507 U.S. 546, 71 AFTR2d 93-1380 (1993) (which rejected the Service's 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.[44]

The IRS reconsidered its position, however, and concluded in CCA 200911006 that the analysis of *Newark Morning Ledger* applies in determining whether intangibles constitute goodwill or going-concern value within the meaning of Reg. 1.1031(a)-2(c)(2).

Accordingly, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property under Section 1031, assuming all other requirements of Section 1031 are satisfied (including the nature and character rules of Reg. 1.1031(a)-2(c)(1)). In the opinion of the Office of Associate Chief Counsel, except in rare and unusual situations, such intangibles can be separately described and valued apart from goodwill. Therefore, the Service will not follow the positions expressed in TAM 200602034 and FAA 20074401F on this issue.

IDENTIFICATION

An exchange of intangible assets was not the only issue in TAM 200602034. In addition, the Service also addressed compliance with the 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 at the beginning of this article in connection with the identification requirement), the IRS concluded that a taxpayer may, in effect, 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.

FUNDS HELD BY QIs

Final Regulations govern the tax treatment of Section 1031 qualified escrow accounts and qualified trusts.[45]

Originally, Proposed Regulations issued in 1999 generally provided that the taxpayer (the transferor of the property) was the owner of the

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

[45] 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).

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.

TRANSFERS OF PROPERTY TO RICs AND REITs

Reg. 1.337(d)-7 generally provides that if property of a C corporation becomes the property of a RIC or REIT by the qualification of that C corporation as a RIC or REIT or by the transfer of assets of that C corporation to a RIC or REIT, then the RIC or REIT will be subject to tax on the net built-in gain in the converted property under the rules of Section 1374 and its Regulations, as if the RIC or REIT were an S corporation.[46]

Commentators expressed concern that this general rule may inappropriately expose property transferred in certain exchanged-basis transactions—specifically, like-kind exchanges and involuntary conversions—to this treatment. In these transactions, the C corporation transferor replaces property it transferred to a RIC or REIT with property that has an equivalent basis and built-in gain, and as a result, the built-in gain remains subject to corporate tax in the hands of the transferor. Therefore, there would not be any circumvention of the purposes of the amendments made to Sections 336 and 337 by TRA '86 (commonly referred to as the repeal of the *General Utilities* doctrine), which require corporations to recognize gain or loss on the distribution of property in connection with complete liquidations other than certain subsidiary liquidations. Furthermore, Reg. 1.337(d)-4(b)(3) provides an exception in an analogous context (where a C corporation transfers all or substantially all of its assets to a tax-exempt entity) to the extent the transaction qualifies for nonrecognition treatment under Section 1031 or 1033.

Addressing these concerns, Treasury and the IRS issued proposed amendments to Reg. 1.337(d)-7.[47] The Proposed Regulations provide an exception from the general rule of the current Regulations for a transfer of property by a C corporation to a RIC or REIT to the extent that the transfer qualifies for nonrecognition treatment under either Section 1031 or 1033.[48]

EXAMPLE: X, a REIT, owns a building that it leases for commercial use with a value of $100 and an adjusted basis of $60 (property A). Y, a C corporation not related to X, owns a building that it leases for commercial use with a value of $100 and an adjusted basis of $70 (property B). If Y transfers property B to X in exchange for property A in a transaction that qualifies for nonrecognition treatment under Section 1031, then the conversion transaction will not be subject to Section 1374 treatment under Reg. 1.337(d)-7(a). In such a transaction, Y's basis in property A is derived from its basis in property B, and thus reflects the built-in gain. At the same time, X's basis in property B has no relation to Y's basis therein.

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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46 This treatment does not apply, however, if the C corporation transferor elects to recognize gain and loss as if it sold the converted property to an unrelated party at FMV.

47 REG-139991-08, 4/16/12.

48 Prop. Reg. 1.337(d)-7(d)(3).