The 'State of the Art' in Like-Kind Exchanges—2019

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A review of recent legislation, IRS guidance, and court decisions provides insights on the current use of and restrictions on like-kind exchanges.

Complications, variations, nuances, idiosyncrasies, and significant new changes resulting from the recent tax reform legislation abound in the rules that govern nonrecognition exchanges. Different types of property may no longer be exchangeable (personal and intangible). Different types of real property, different ownership structures, and different forms of exchanges (deferred, reverse) still may affect the bottom line, which is whether the taxpayer can defer recognizing gain.

A little more than 18 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, a fourth in 2009, a fifth in 2012, and most recently in 2015.[1] It is time for the next installment addressing developments in this area.

Background

The statutory revisions to Section 1031 as part of tax reform, the latest guidance from the IRS, and the recent court decisions in this area are examined below. The matters discussed include:

- The changes to Section 1031 from the Tax Cuts and Jobs Act (TCJA) and the implications.
- Elaboration in satisfying the "use in a trade or business" requirement.
- Developments concerning non-safe harbor reverse exchanges.
- Cautionary tales involving failed exchanges, related-party exchanges, and swap and drops.

Requirements for a Tax-Free Exchange

Under Section 1031(a), no gain or loss is recognized on the exchange of real 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. Prior to the enactment of the TCJA, Section 1031(a) applied to the like-kind exchange of any type of property, other than certain excluded property types. In a major change to the like-kind exchange rules, Section 1031(a) now applies only to the like-kind exchange of real property. Taking this change into account, there are four requirements for a tax-free exchange:

1. There must be an "exchange" of relinquished property for replacement property.
2. Each "property" must be real property that is not held primarily for sale.
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 and Boot

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, but the regulations expressly permit 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 relinquished property also may be offset by cash given by the taxpayer to the other party.

It is a common misconception that a taxpayer must "equalize" the debt in an exchange. In fact, boot will be avoided if the taxpayer satisfies two tests in the exchange: (1) the purchase price of the replacement property equals or exceeds the sale price of the relinquished property, and (2) the amount of equity used to acquire the replacement property equals or exceeds the equity received on the sale of the relinquished property. This two-part test does not directly refer to debt, although any debt that encumbers the relinquished property will reduce the taxpayer's equity in that property.

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).

Related Parties

Section 1031(f) provides special limitations for exchanges between certain related parties. The impetus for these related-party restrictions was basis swapping by taxpayers pursuant to the basis rules of Section 1031(d) (property acquired in a like-kind exchange generally takes the basis of the property relinquished). Taxpayers were exchanging low-basis property intended to be cashed-out for high-basis property owned by an affiliate, and then having the affiliate sell the property (now with a much higher basis) in order to reduce gain or increase loss on the property to be cashed-out. Under current law, if a taxpayer exchanges property with a related person, nonrecognition treatment otherwise would apply to such exchange, and 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 generally there is recognition of the deferred gain or loss as of the date of the disposition of the property received in the initial exchange.

Multiparty and Deferred Exchanges

In a multiparty exchange, the taxpayer transfers property to a party who desires to own the taxpayer's property (a buyer) or to a party who holds property that the taxpayer wants (a seller). If the transfer is to a buyer, the buyer, in turn, acquires the replacement property desired by the taxpayer from a seller and transfers it to the taxpayer. If the transfer is to a seller, the seller conveys the replacement property to the taxpayer and sells the taxpayer's former property to the buyer. These are referred to as "buyer-cooperating" and "seller-cooperating" exchanges.

A significant advance in procedures used in multiparty exchanges arose from the Regulations allowing deferred exchanges—often referred to as *Starker* transactions after the Ninth Circuit decision that first sanctioned such arrangements. The 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), which allows the transferor of relinquished property up to 45 days to identify replacement property and 180 days to close on the acquisition. The Regulations importantly contain safe harbors that taxpayers now use to avoid constructive receipt of the proceeds from relinquished property.

Reverse Exchanges

In a reverse exchange, the replacement property is acquired *before* the sale of the taxpayer's relinquished property to a third-party buyer. The IRS has provided

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an important safe harbor for qualifying a reverse exchange. Subsequent guidance, however, limits the application of the safe harbor, providing that the safe harbor does not apply if the taxpayer previously owned the intended replacement property within 180 days prior to the exchange. Nevertheless, if the replacement property was previously owned by a *related* party, there appears to be a manner sanctioned by the IRS under which such property may be used in a reverse exchange within the safe harbor.

What Is Like Kind

The TCJA limited like-kind exchanges to "real property" and took the other exceptions previously found in Section 1031(a)(2) out of the Code. After the enactment of the TCJA, it is unclear to what extent the requirement of properties being "of like kind" may or may not apply. As a general matter, an ownership interest in real property is treated as like-kind property with respect to any other ownership interest in real property, except that real property located in the United States is not like-kind with respect to property located outside of the United States.[2] Unfortunately, the changes to Section 1031 under the TCJA failed to define what constitutes real property. One would assume that at some point regulations will be promulgated that will define real property, but until that time the best place taxpayers have to look is to the current regulation, case law, and IRS guidance and their approach to which properties count as property that is like-kind to real property.

Recent guidance on this subject can be found in Ltr. Rul. 201706009. In the ruling, the taxpayer is a communications services provider that offers communications infrastructure to its customers and currently owns fee simple or long-term leasehold interests in multiple wireless communication tower sites across the nation. Each tower site consists of fencing around the tower site, an antenna support structure for mounting antennas that are affixed to the land by a concrete foundation and attachment hardware (such as bolts and lashings), a nearby equipment hut with HVAC systems installed in the hut, and the land underlying the site itself ("Towers"). All of Taxpayer's Towers are permanently affixed to the land or would be extensively damaged if removed.

Taxpayer contemplated exchanging its Towers for fiber-optic and copper cables installed either above or below ground and various other associated properties, including telephone poles for carrying the cables, underground conduits, concrete pads, attachment hardware, pedestals, guy wires, and anchors ("Cable Distribution Systems"). The Cable Distribution Systems are permanently affixed to the land or intended never to be removed until the end of their respective useful lives.

The IRS noted the case law clarifying that state law property classifications are not the sole basis for determining whether the Towers and the Cable Distribution Systems are like-kind property for Section 1031 purposes. The IRS concluded that Taxpayer's Towers and the Cable Distribution Systems are like-kind property for purposes of Section 1031 because both transmit or support the transmission of telecommunication signals across distances, neither are used for other activities, and both are, or are intended to be, permanently affixed to land. The ruling applied only to Towers and the Cable Distribution Systems being transferred and received by Taxpayer as relinquished or replacement property, respectively, in the exchange that are affixed or embedded in real property held in fee simple or similar interest or under a long-term lease, easement, right of way, or similar long-term right-of-use arrangement, in each case having a duration of 30 years or more including optional renewal periods exercisable by the tenant or right of use holder.

Although this recent guidance is helpful, it does not address the most pressing questions which now confront taxpayers, such as whether improvements to real estate or fixtures (including removable fixtures such as dishwashers, washers/dryers, and the like) are treated as part of the real property or whether there will be some type of de minimis exception to address such items. In addition, it is not clear whether a taxpayer will be able to engage in a like-kind exchange with respect to improvements for which depreciation recapture under Section 1245 applies. These and related questions will hopefully be answered soon in guidance on this topic.

Use In a Trade or Business

A taxpayer's intent to hold a property for productive use in a trade or business or for investment is a question of fact that must be determined at the time of the exchange. Taxpayers bear the burden of proving that they had the requisite investment intent. The investment intent must be the taxpayer's primary motivation for holding the exchanged property in order for the property to qualify as held for investment for purposes of Section 1031.

CCA 201601011

Partnership "P" owns multiple aircraft which are leased to Partnership "O" which is the primary business entity of the O group of entities, which includes P and other entities. O's business activities involve air travel, particularly by its executives. For both business and legal reasons, the aircraft are owned by P, in an entity separate from the main business entity, O, and leased to O. The aircraft are the only operating assets of P, but P also owns interests in other entities in the O group of entities. The aircraft are principally used by two of O's senior executives—A and B, who use the aircraft variously for business purposes and for personal purposes. Thus, the aircraft serve a business purpose for O both in terms of business travel and as an employment perk for its senior executives. To the extent A and B use the plane for personal purposes, they include the required amount in income as compensation under IRS regulations. A and B, who own interests in O through wholly

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); Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2009," 110 JTAX 27 (January 2009); Lipton and Gruen, "The 'State of the Art' in Like-Kind Exchanges, 2012," 116 JTAX 246 (May 2012); and Lipton, Grilli, and Pollack, "The 'State of the Art' in Like-Kind Exchanges—2015," 124 JTAX 5 (January 2016).

2 Compare Section 1031(h) with Reg. 1.1031(a)-1(b).

owned entities, also each own 50% of P through wholly owned entities.

In Year 1, P exchanged the relinquished aircraft for the replacement aircraft. Both the relinquished and replacement aircraft were leased under a "dry" lease, under which the lessee provided flight crew and other services pertaining to the aircraft. The lease payments were designed to cover the aircraft's carrying costs and were not designed to generate meaningful economic profit.

The field's position was that P did not hold either the relinquished or replacement aircraft for productive use in a trade or business. Because the term "held for productive use in a trade or business" is not defined in the Code or Regulations, the field relied on Section 183 and accompanying cases and regulations.

Chief Counsel agreed with the field that A's and B's use of the aircraft for personal purposes was not relevant in answering the question at issue. Chief Counsel did not agree that Section 183 standards should be used to evaluate whether the aircraft are property held for productive use in a trade or business because there is no authority suggesting that such standards should be used. Moreover, Chief Counsel did not see P's lack of intent to make an economic profit on the aircraft rental as determinative of the question of whether P held such aircraft for productive use in a trade or business. Chief Counsel was of the view that many businesses hold and use properties in a way that, if the use of the property were viewed as an activity, do not and could not generate profit. Nevertheless, the property itself is held for productive use in that business.

Chief Counsel appeared alarmed by its doubt that the field would have raised the issue at all if O owned the aircraft or if O was the 100% owner of P. Chief Counsel found it important to point out that businesses, for any number of reasons, opt to hold property, especially aircraft, in a separate entity, and that if they were to disallow Section 1031 treatment based on the entity structure presented here, businesses would be forced to structure their transactions in inefficient and potentially risky ways to achieve Section 1031 treatment. Chief Counsel keenly saw this as a bad policy road to go down.

Thus, Chief Counsel was of the view that the entity structure in the present case should not be used as grounds that the aircraft fails to qualify as property held for productive use in a trade or business. O operates a legitimate business enterprise and requires private aircraft to be available to its senior executives. However, for business and legal reasons, the aircraft are owned not by O but by P, a related entity, and leased to O for an amount not intended to generate a profit for P. Chief Counsel concluded that the aircraft are held for productive use in a trade or business for purposes of Section 1031. The fact that P charges below-market rent and A and B, rather than O, own P, may implicate other Code provisions and tax issues but do not change the analysis under Section 1031 with respect to the particular question of the "held for productive use in a trade or business" requirement.

CCA 201605017

Individual "A" owns aircraft through a disregarded single-member LLC which provides management, accounting, financial, administrative, and other business services to A's businesses and investments. These businesses and investments are dispersed throughout the United States so that A and the LLC have some business and investment need for the aircraft. In Year 1, the LLC exchanged the aircraft (relinquished aircraft) for replacement aircraft. The field asserted that because only a certain percent of the flights in the year of the exchange were business or investment related (which percentage was disputed by the taxpayer), the aircraft was not "held for productive use in a trade or business or investment" within the meaning of Section 1031.

Chief Counsel noted they were unaware of any case law dealing with whether property used both personally and in connection with a business or investments is to be treated as two properties or one for purposes of meeting the "held for" requirement of Section 1031. Chief Counsel thought the plain language of Section 1031 suggests that property either meets the "held for" requirement or it does not. Chief Counsel reasoned that, if property used for business and personal purposes was to be treated as two properties, then gain or loss would be recognized on an exchange of that property contrary to the language in the statute.

Moreover, Chief Counsel pointed out that the IRS had an opportunity in Rev. Proc. 2008-16, in the context of a dwelling unit that is occasionally used for personal purposes, to treat one property as two for purposes of determining whether Section 1031 applies when that property is exchanged, and the IRS did not choose to do so. Accordingly, Chief Counsel concluded that there is no legal support for treating the relinquished aircraft as two properties for purposes of Section 1031.

The relinquished aircraft should be treated as one property that either meets or fails "the held" for requirement of Section 1031(a)(1). In this intensely factual inquiry, Chief Counsel noted that the taxpayer's intentions regarding the property are critical. Section 1031 does not provide for a simple quantitative-use formula. There are no authorized absolute mechanical or quantitative tests for measuring intent, and no safe harbor rules have been promulgated for these circumstances. Rather, intent must be determined by the unique facts and circumstances extant in each given transaction.

Chief Counsel agreed that the percent figure cited by the field (which percentage was not disclosed) does suggest that the property is not held for productive use in a trade or business or for investment, but advised that additional facts should be considered:

1. Measurement of business/investment use versus personal use based on flight hours, not just flights.
2. Percentages of business/investment use versus personal for flights and flight hours for the year before the year of the exchange.
3. Which flights and flight hours were determined to be repositioning flights and the nature of the flight following the repositioning flight.

In further developing the facts, Chief Counsel advised that if the field determined that over 50% of the use of the aircraft was for personal purposes, then it would agree that the aircraft was not held for productive use in a trade or business or for investment. However, it was then cautiously footnoted that the foregoing sentence should not be read to imply that a taxpayer whose personal use of property is less than 50% has met the "held for" requirement for that property. Instead, close scrutiny should be used for any property the taxpayer uses for personal purposes.

What Property Can Be Exchanged

A recent letter ruling and court decision provide guidance on the type of property that can qualify for a Section 1031 exchange.

Ltr. Rul. 201622008

Taxpayer operates Property as a commercial office rental property and intended to triple net lease the Property to an unrelated third party ("New Co-Owner"). Taxpayer and New Co-Owner will enter into an Option Agreement under which Taxpayer will have an option to sell any or all of its interest in the Property to New Co-Owner at any time before the fifth anniversary (the "Put"), and New Co-Owner will also have an option to acquire the entire remaining interest then held by Taxpayer beginning on the seventh anniversary (the "Call"). The purchase price for the exercise of the Put or the Call will be based on the fair market value of the Property at the time of the execution of the Option Agreement, increased at each anniversary date by a reasonable appreciation factor.

The Property will be owned by the Taxpayer and New Co-Owner pursuant to a tenants-in-common agreement that will run with the land (the "Co-Ownership Agreement"). Taxpayer represented that neither co-owner will provide financing to the other co-owner to acquire a tenancy-in-common interest in the Property. Each co-owner will share the indebtedness on the Property in proportion to that co-owner's interest in the Property. Taxpayer represented that the co-owners may, but are not required to, enter into a management agreement with either Manager or JV.

The mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. In Rev. Proc. 2002-22,[3] the IRS provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes. In Ltr. Rul. 201622008, the IRS concluded that the agreements will satisfy all of the conditions set forth in Rev. Proc. 2002-22.

Specifically regarding voting, section 6.05 of Rev. Proc. 2002-22 provides, in part, that the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. Relating to hiring a manager, section 6.12 of Rev. Proc. 2002-22 provides, in part, that the co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. Although not an affirmative consent, the right of any co-owner to terminate the management agreement at any time with 20 days of notice was found to satisfy the conditions in sections 6.05 and 6.12 of Rev. Proc. 2002-22 regarding unanimous annual renewals of any management agreement.

Section 6.10 of Rev. Proc. 2002-22 provides that a co-owner may not acquire a put option to sell the co-owner's undivided interest to another co-owner. The IRS concluded that is not what will happen in this case. Taxpayer's Put was not an option to sell an existing undivided interest that was previously acquired by Taxpayer. Rather, the Put is an option to sell property held by Taxpayer prior to entering into the proposed transaction. The purpose of the put prohibition is not applicable to this case. Regarding the exercise price, although section 6.10 of Rev. Proc. 2002-22 requires that the exercise price be the fair market value at the time of exercise, the certain percentage appreciation factor was found to adequately approximate the fair market value of the Property.

Based on the facts submitted and representations made, the IRS concluded that, if Taxpayer sells a tenancy-in-common interest in the Property to New Co-Owner pursuant to the terms described in this ruling, an undivided fractional interest in the Property will not be an interest in a business entity under Reg. 301.7701-2(a) for purposes of qualification of the undivided fractional interests as eligible relinquished property under Section 1031(a).

Exelon[4]

An electric utility company sold its power plants and deferred tax on the gain by structuring a series of like-kind exchanges using sale-leasebacks of interests in other power plants with two unrelated tax-exempt entities.

To carry out its purported like-kind exchanges, Exelon leased an out-of-state power plant from a tax-exempt entity for a period longer than the plant's estimated useful life. Exelon then immediately leased the plant back to that entity for a shorter sublease term and provided to the tax-exempt entity a multimillion-dollar accommodation fee for engaging in the transaction, along with a fully-funded purchase option to terminate Exelon's residual interest at the end of the sublease. Exelon asserted that it had acquired a genuine ownership interest in each of the plants as a result of the transactions, thus qualifying them as like-kind exchanges under Section 1031, entitling it to defer tax on the gain it realized from the sale of its power plants. Exelon also claimed deductions on its return for depreciation, interest and transaction costs as lessor of the plants.

The IRS disallowed the like-kind exchanges because they involved sale-in, lease out (SILO) arrangements with the owners of the power plants. According

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[3] 2002-1 CB 733.

[4] 122 AFTR2d 2018-6138 (CA-7, 2018) *aff'g* 147 TC 230 (2016).

to the IRS, these transactions did not transfer genuine ownership of the underlying property to Exelon, so that the like-kind exchanges were ineffective.

The Tax Court agreed with the IRS that in substance Exelon's transactions most closely resembled loans from Exelon to the tax-exempt entities. Exelon did not face any significant risks indicative of genuine ownership. The transactions' circular flow of money precluded Exelon from having any real investment in the plants, despite using its own funds (as opposed to borrowed funds in a traditional SILO) to finance the headlease payments. In addition, the court found that each sublease allocated all costs and risks associated with the plants to the sublessees, and that each transaction's defeasance structure left Exelon able to fully recover its investment in the unlikely event of either a lessee bankruptcy or an early termination of the sublease. There was a reasonable likelihood that the lessees would each exercise its purchase option, meaning Exelon's profit was fixed at the onset of each transaction, and thus Exelon did not acquire any benefits or burdens of ownership.

Exelon contended on appeal that the Tax Court had treated its transaction like tax shelters which lacked economic substance, whereas Exelon had only obtained tax benefits under Section 1031, which are benefits conferred by Congress. The Seventh Circuit responded that the Tax Court had focused on the substance of the underlying SILO transactions rather than their form in order to determine whether Exelon had acquired the benefits and burdens of ownership of the plants. To be entitled to the benefits of a like-kind exchange, Exelon had to acquire a genuine ownership interest in the replacement plants.

The Seventh Circuit concluded that the net leases of the plants under the SILO transaction allocated all of the costs and risks associated with the plants to the sublessees (and not to Exelon). When this limited risk was combined with the defeasance structure and circular cash flows, Exelon did not face any significant risk indicative of genuine ownership of the plants. Exelon's argument that it faced risk from a potential bankruptcy of the underlying lessees was rejected as contrary to the facts and Exelon's own conclusion that the risk of bankruptcy was very low in this case.

Exelon also argued that it faced real risk at the end of the subleases that the sublessee may not exercise its option at the end of the initial lease term. The Tax Court had concluded that it was reasonably likely that the options would be exercised, while Exelon claimed that the option should not be treated as likely to be exercised unless the lessee was economically compelled to do so. The Seventh Circuit held that a reasonable expectation or likelihood was required and not economic compulsion.

Exelon next argued that the Tax Court erred in its application of the reasonably likely standard. The Seventh Circuit again disagreed, accepting the expert opinion furnished at trial by the IRS and rejecting the conclusions that the accounting firm had reached. The Tax Court also rejected the accounting firm's appraisals because it found that Exelon's outside counsel had interfered with the integrity and independence of the appraisal process by providing the accounting firm with the wording of the conclusions it expected to see in the final appraisal reports. The Seventh Circuit also concluded that there was a more fundamental problem with Exelon's position that the set purchase option prices far exceeded the fair market value of the plants at the end of the subleases. Here, the sublessees could exercise the purchase options without paying a single cent of their own money. Because the sublessees did not retain any of the money set aside for the purchase option if they did not exercise it, they had no economic incentive not to do so.

Replacement property in a like-kind exchange must be an ownership interest in the replacement property. This case demonstrates how the acquisition of a financial interest without the benefits and burdens of ownership of the property is not sufficient and could cause an intended exchange to fail. A related question under Section 1031 involves the acquisition of leasehold interests which have a long term. Taxpayers who acquire leasehold interests must make certain that the substance of such interests is neither a loan nor a property interest recharacterized as a loan under Section 467. Section 1031 requires that both the relinquished and replacement properties are real property interests that will be characterized as such; a property interest that lacks benefits and burdens of ownership is not sufficient.

Deferred Exchanges

As briefly discussed above, deferred exchanges are often referred to as *Starker* transactions after the Ninth Circuit decision that first sanctioned such arrangements. In *Starker*,[5] 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 relinquished property up to 45 days to identify replacement property and 180 days to close on the acquisition of the replacement property.

The Identification Rules

The taxpayer may identify as replacement property any three properties or, if more than three, any number of multiple properties with a fair market value (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 due to the lack of need to establish fair market values of any property involved.

The Safe Harbors

The key issue in deferred exchanges is, for the purposes of Section 1031, that the taxpayer never actually or constructively receive the non-like kind proceeds of the relinquished property that are used to acquire the replacement property. Reg. 1.1031(k)-1(g) provides safe harbors for taxpayers to avoid actual or constructive receipt for purposes of Section 1031. The safe harbors provide rules for security and guarantee agreements used to ensure the transfer of the replacement property; escrow accounts and trusts that can be used to hold the cash proceeds of a deferred exchange before they are used to acquire replacement property; and, perhaps most importantly, the rules for the use of a qualified intermediary (QI) to facilitate a deferred exchange.

Qualified Intermediaries

In an exchange using a QI, the taxpayer transfers the relinquished property to the QI. Generally, the QI will sell the relinquished property and use the proceeds to purchase replacement property that is then conveyed to the taxpayer. In such a transaction, the subsequent receipt of like-kind replacement property by the taxpayer is treated as an exchange, and the QI's receipt of the cash proceeds from the sale of the relinquished property will not be treated as actually or constructively received by the taxpayer.

Disqualified Person

A QI must satisfy a number of requirements, including the requirement that the QI not be a "disqualified person," which term includes an agent of the taxpayer at the time of the transaction, such as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent within the two-year period ending on the date of the transfer of the first of the relinquished properties. Persons who bear a relationship described in Section 267(b) (e.g., family members including ancestors and lineal descendants) are also disqualified persons. Case law and a private letter ruling discussed in "The 'State of the Art' in Like-Kind Exchanges—2015"[6] illustrated the importance of following the letter of the law with respect to "disqualified person" treatment.

Constructive Receipt

Constructive receipt is a concept generally used in tax accounting, but that has special importance and application with respect to deferred like-kind exchanges, because if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will be a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Despite the restrictions that must be imposed on proceeds from the sale of relinquished property received by a QI, an exchanging taxpayer may still enjoy some benefit from the use of such funds without being treated as constructively receiving the funds. For instance, the IRS released INFO 2018-0003 on 1/5/2018, stating that a "QI may use the proceeds from the sale of the relinquished property to fund the construction of the replacement property," rather than obtain a construction loan, so long as the other requirements of Section 1031 are satisfied.

Ltr. Rul. 201825024

Taxpayer entered into an exchange agreement with a QI to effect a tax-deferred exchange of commercial real property. In Year 2, Taxpayer signed and timely filed the Year 1 federal individual income tax return that included Form 8824, Like-Kind Exchanges, reporting recognized gain that represents the amount of boot received on the exchange. Taxpayer in effect elected out of the Section 453 installment method in reporting the entirety of the gain.

In Year 5, as a result of a state income tax examination, Taxpayer, accountant, and representative became aware that the gain recognized in Year 1 could have been deferred until Year 2 under the installment method. By his own admission, accountant incorrectly advised Taxpayer that the Year 1 Form 1099-S reporting the first leg of the exchange required the gain to be reported in Year 1. This is contrary to a correct understanding that the Section 453 installment method may apply and that gain may be deferred until after the second leg of the exchange in Year 2.

Shortly after becoming aware of the error, representative promptly filed the private letter ruling request on behalf of Taxpayer, and Taxpayer concurrently and timely filed an amended return for Year 1. The amended return was filed as a protective claim for a refund pending the determination of this ruling request. Taxpayer was granted permission to revoke the election out of the installment method for Year 1. Taxpayer was required to file an amended federal income tax return for Year 2 to report the taxable gain recognized on the exchange, and also file amended tax returns for Year 3 and Year 4 to reduce any tax carryforwards affected by the amended tax returns filed in Year 1 and Year 2.

TCJA's Elimination of LKE Programs

Rev. Proc. 2003-39[7] provided guidance on the qualification of LKE Programs. The purpose was to provide safe harbors with respect to programs involving ongoing exchanges of *tangible personal property* using a single intermediary. The TCJA's limitation that Section 1031 apply only to real property rendered Rev. Proc. 2003-39 irrelevant. However, guidance involving such programs is still relevant to understanding how certain aspects of Section 1031 apply in practice.

Ltr. Rul. 201648013

Taxpayer implemented a LKE Program for the purpose of engaging in like-kind exchanges involving leased properties, financed with funds borrowed from unrelated, third-party lenders. The loans were used exclusively by Taxpayer to purchase new properties. Each loan was secured by a pool of separately identified properties as well as each property's associated lease contract and related lease and residual income stream. Pursuant to the terms of a Master Exchange Agreement and Loan Security Agreement, the QI was obligated to use relinquished property proceeds to repay loans secured by the relinquished property. The IRS concluded that for purposes of Reg. 1.1031(k)-1, Taxpayer did not have actual or constructive receipt of such proceeds. It further concluded that the QI's repayment of the relinquished property debt with the relinquished property proceeds would be treated as liability relief for purposes of the boot netting rules under Reg. 1.1031(b)-1(c).

Reverse Exchanges

In a reverse exchange, the replacement property is acquired *before* the sale of the taxpayer's relinquished property. Because the IRS stated that the regulations for deferred exchanges under Section 1031(a)(3) did not apply to reverse-*Starker* exchanges, prior to 2000, taxpayers attempted to use a wide variety of accommodation ownership arrangements and related mechanisms to facilitate reverse exchanges.

In the interest of sound tax administration, the IRS provided in Rev. Proc.

NOTES

5 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979).

6 Note 1, *supra*.

2000-37[8] a workable means of qualifying an accommodation ownership arrangement if there was a genuine intent to accomplish a like-kind exchange at the time the taxpayer arranged for the accommodation party's acquisition of the replacement property, so long as the taxpayer actually accomplished the exchange within a short time thereafter. A safe harbor allows a taxpayer to treat an exchange accommodation titleholder (EAT) as the owner of property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying reverse exchange.

Moreover, the procedure gives important flexibility to taxpayers and EATs in setting up a qualified exchange accommodation arrangement (QEAA). For example, the IRS has issued rulings concluding that Rev. Proc. 2000-37 does not prohibit an accommodation party from serving as an EAT to multiple related taxpayers under multiple and simultaneous QEAAs for the same parked property, so long as each taxpayer has a bona fide intent to acquire the replacement property pursuant to each of its QEAAs.[9] The use of multiple separate QEAAs for parking the same property held by an EAT practically enables a workaround when a taxpayer and its affiliates own various properties being offered for sale but are not sure which relinquished property they will sell, or could sell in time.

Services Performed by the EAT

Section 3.03 of Rev. Proc. 2000-37 states that services for the taxpayer in connection with a person's role as the EAT in a QEAA are not taken into account in determining whether that person or a related person is a disqualified person. Section 4.03 of the Revenue Procedure lists permissible arrangements that will not cause property to fail to be treated as being held in a QEAA, regardless of whether such arrangements contain terms that typically would result from arm's-length bargaining between unrelated parties:

1. An EAT that satisfies the requirements of the QI safe harbor may enter into an exchange agreement with the taxpayer to serve as the QI in a simultaneous or deferred exchange of the property.
2. The taxpayer or a disqualified person guarantees some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnifies the EAT against costs and expenses.
3. The taxpayer or a disqualified person loans or advances funds to the EAT or guarantees a loan or advance to the EAT.
4. The property is leased by the EAT to the taxpayer or a disqualified person.
5. The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the EAT with respect to the property.
6. The taxpayer and the EAT enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the EAT.
7. The taxpayer and the EAT 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 upon the EAT's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the EAT.

This list is non-exclusive. As discussed in "The 'State of the Art' in Like-Kind Exchanges—2015," an EAT is generally permitted to perform services that are reasonably related to facilitating the exchange without disqualifying its status as such.

Rev. Proc. 2004-51

The IRS modified Rev. Proc. 2000-37 in Rev. Proc. 2004-51[10] to provide that the reverse-exchange safe harbor does not apply if the taxpayer owns the property intended to qualify as replacement property within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an EAT pursuant to a QEAA.

By its terms, however, Rev. Proc. 2004-51 applies only when the replacement property is owned by the taxpayer and does not refer to replacement property owned by a related party. Rev. Proc. 2004-51 further stated that the IRS and Treasury Department intended to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party, the accommodation party makes improvements to the land, and it then transfers the leasehold with the improvements to the taxpayer in exchange for other real estate. Ten years later, the IRS ruled that such transactions are within the safe harbor of Rev. Proc. 2000-37.[11]

Non-Safe Harbor Transactions: *Bartell* and AOD 2017-6

For transactions outside the scope of the safe harbor, the IRS requires an exchange facilitator to possess the benefits and burdens of ownership in order to be treated as the owner of the replacement property for purposes of Section 1031.

The IRS's position was rejected in *Estate of Bartell*,[12] a case involving a transaction that commenced prior to the September 2000 effective date of Rev. Proc. 2000-37.[13] In *Bartell*, a taxpayer, intending to engage in a like-kind exchange, entered into an agreement with an exchange facilitator (EF) to purchase replacement property from Seller. EF acquired the property from the Seller on 8/1/2000, after which the taxpayer constructed a store on the replacement property and then, in June 2001, began to lease the replacement property (including the store) from EF. Later, in December 2001, the taxpayer disposed of a different property, the relinquished property, through a qualified intermediary (QI) and had the QI acquire the replacement property from EF in order to complete a like-kind exchange with respect to the relinquished property that was sold. The EF held title to the replacement property for 17 months.

The IRS viewed the taxpayer as owning the replacement property under a "benefits and burdens" analysis, thereby precluding the taxpayer from receiving such property in a like-kind exchange

18 months later. The taxpayer argued that both the Tax Court and the Court of Appeals for the Ninth Circuit, to which an appeal of *Bartell* would ordinarily lie, have expressly rejected the proposition that a person who takes title to the replacement property for the purpose of effecting a Section 1031 exchange must assume the benefits and burdens of ownership in that property to satisfy the exchange requirement.

The Tax Court held in favor of the taxpayer, relying on prior case law that established that where a Section 1031 exchange is contemplated from the outset and a third-party exchange facilitator takes title to the replacement property before the exchange, the exchange facilitator need not assume the benefits and burdens of ownership of the replacement property in order to be treated as its owner for Section 1031 purposes. Distinguishing *DeCleene*,[14] a case on which the IRS based its position, the Tax Court emphasized that it employed a benefits and burdens test in *DeCleene* due to the taxpayer's failure to use a third-party exchange facilitator from the outset of the exchange.

The IRS did not appeal its loss in the Tax Court to the Ninth Circuit, presumably because the IRS recognized that the precedents in that circuit were not favorable to its position. Rather, on 8/14/2017, the IRS issued Action on Decision 2017-06[15] (the "AOD"), in which the IRS announced that it would not acquiesce in the Tax Court's decision in *Bartell*.[16] Specifically, in determining whether a reverse exchange outside the scope of Rev. Proc. 2000-37 meets the requirements of Section 1031, the IRS will not follow the principle in *Bartell* that an exchange facilitator may be treated as the owner of property regardless of whether it possesses the benefits and burdens of ownership. Thus, according to the AOD:

> Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. The Service will not follow the Tax Court's opinion in Bartell to the extent the opinion provides otherwise.

The non-acquiescence means that taxpayers who desire to engage in reverse exchanges will now face a clearer decision tree. On one side are exchanges within the safe harbor, which will clearly be accepted by the IRS. It can be anticipated that most tax practitioners will advise their clients to avail themselves of the safe harbor when it is suitable, because there is tax certainty notwithstanding that the taxpayer effectively has the benefits and burdens of ownership of the replacement property before the relinquished property is sold.

On the other hand, if the exchange does not comply with the safe harbor for any reason (such as a reverse exchange where construction of the replacement property will take considerably more than six months), the taxpayer will need to determine whether the exchange facilitator will have the benefits and burdens of ownership. The AOD indicates that if the exchange facilitator has the benefits and burdens of ownership (without clearly stating what those would be), the IRS will respect the reverse like-kind exchange, presumably without regard to the time period during which the exchange facilitator held the property. On the other hand, if the exchange facilitator lacks the benefits and burdens of ownership at any time, the IRS indicated that it would treat the disposition of the relinquished property as a sale outside of Section 1031.

Accommodation Parties

Whether a taxpayer is engaging in a deferred exchange or in a reverse exchange, the taxpayer will need an accommodation party to facilitate the transaction. This need has resulted in the creation of an industry of qualified intermediaries, EATs, and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under Section 1031. When engaging an intermediary, taxpayers need to be wary not only of their arrangement complying with the requirements for a valid Section 1031 exchange, but also of the economic consequences of the engagement. As noted above, although transactions with an intermediary are formalistic, they are also legally binding and can give the intermediary too much control over the subject matter of the exchange.

The taxpayer in *Germinaro v. Fidelity Ntnl. Title Insurance Co.*[17] found this out the hard way. In *Germinaro*, the taxpayer engaged LandAmerica 1031 Exchange Services, Inc. (LES) to act as a qualified intermediary in its like-kind exchange. LES was a subsidiary of an investment company, LandAmerica Financial Group, Inc. (LFG). Proceeds from the sale of the taxpayer's relinquished property were kept in an account that was comingled with all of LES's other funds and, when LFG ran into liquidity problems, it used the funds in the comingled account to stay afloat. The case is about whether the QI transaction was a Ponzi scheme subject to a RICO claim. The Third Circuit concluded that it was not because RICO requires that racketeering activity take place for at least 12 months and that threshold was not satisfied. The takeaway, however, is that taxpayers need to take care and understand that intermediary agreements are not pure tax formality and that economic consequences need to be taken into account in setting boundaries of the intermediary's rights.

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7 2003-1 CB 971.

8 2000-2 CB 308.

9 See Ltr. Rul. 201242003 and Ltr. Rul. 201416006, discussed in "The 'State of the Art' in Like-Kind Exchanges—2015," *supra* note 1.

10 2004-2 CB 294.

11 See Ltr. Rul. 201408019, discussed in "The 'State of the Art' in Like Kind Exchanges—2015," *supra* note 1.

12 147 TC 140 (2016).

13 See Weller, Lipton, Cullen, Grilli, and Renchen, "Tax Court Finally Unveils Reverse Exchange Principle in Bartell But Stay Tuned," 125 JTAX 196 (November 2016).

14 115 TC 457 (2000).

15 2017-33 IRB 194.

16 See Banoff and Lipton, "Living with *Bartell* Uncertainty," 127 JTAX 238 (November 2017).

17 121 AFTR 2d 2018-2158 (CA-3, 2018).

Related-Party Exchanges

As discussed above, Section 1031(f) provides special limitations for exchanges between certain related parties. The impetus for these related-party restrictions was basis swapping by taxpayers pursuant to the basis rules of Section 1031(d) (property acquired in a like-kind exchange generally takes the basis of the property relinquished). Taxpayers were exchanging low-basis property intended to be cashed-out for high-basis property owned by an affiliate, and then having the affiliate sell the property (now with a much higher basis) in order to reduce gain or increase loss on the property to be cashed-out.

Section 1031(f)(1) provides that 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. 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.

Under Section 1031(f)(2), certain dispositions are excepted from this recognition rule. 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 IRS's satisfaction that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax. Lastly, Section 1031(f)(4) provides an anti-abuse rule stating that nonrecognition under Section 1031 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).

Teruya Brothers, Ocmulgee Fields, and *North Central Rental & Leasing*

One way to circumvent Section 1031(f)(1) is through the use of a QI or an EAT as the party through whom the taxpayer conducts an exchange because they are by definition not persons related to the taxpayer. Instead of a taxpayer directly swapping a low-basis property with a related party, a taxpayer could transfer the low-basis property to the buyer through a QI, which uses the proceeds of the relinquished property to purchase the high-basis property from the related party as replacement property. The end-result is exactly the same as a direct swap with the related party.

Such an insertion of a QI was found to be a violation of the Section 1031(f)(4) anti-abuse rule in both *Teruya Brothers, Ltd.*,[18] and *Ocmulgee Fields, Inc.*[19] The Eighth Circuit went even further in *North Central Rental & Leasing LLC*,[20] applying the anti-abuse rule of Section 1031(f)(4) where unnecessary parties were involved in a like-kind exchange and a related party obtained the use of significant amounts of cash on an interest-free basis for up to six months. *North Central* was discussed in detail in "The 'State of the Art' in Like-Kind Exchanges—2015."

Taxpayers must be very careful when bringing a related party into a like-kind exchange transaction in any manner. Notwithstanding, the IRS has ruled that Section 1031(f) does not preclude the benefits of Section 1031 in the case of a series of transactions between related parties if each transaction in the series qualifies under Section 1031(a), and none of the parties receive more than a minimal amount of non-like-kind property.[21]

The Malulani Group

In *Malulani Group, Ltd.*,[22] the taxpayer tried to distinguish itself from *Teruya Brothers* and *Ocmulgee Fields* because it had no prearranged plan to use property from a related person to complete a like-kind exchange and turned to such property only when the deadline to complete its deferred exchange was imminent.

The Malulani Group leased commercial real estate in various states, including Hawaii and Maryland. Its wholly owned subsidiary, MBL, received a letter of intent from an unrelated third party on 10/31/2006, offering to purchase commercial real estate that MBL owned in Maryland. The Malulani Group and MBL searched for suitable replacement property, and MBL engaged FAEC to serve as an intermediary through which the Maryland property could be exchanged. On 1/10/2007, MBL transferred the Maryland property to FAEC, which in turn sold the property to a third party. Thus, MBL had to identify replacement property on or before 2/24/2007 (i.e., 45 days after the sale of the Maryland property).

Between 10/31/2006 and 2/23/2007, brokers presented numerous properties owned by unrelated parties to the Malulani Group and MBL as potential replacement properties. After failed negotiations, MBL identified three potential replacement properties on 2/23/2007, all belonging to MIL, a related party owned 69.67% by the Malulani Group. On 7/3/2007, FAEC purchased certain Hawaii property owned by MIL and transferred such property to MBL as replacement property for the Maryland property.

The IRS argued that MBL's exchange was disqualified from nonrecognition treatment pursuant to Section 1031(f)(4) as a transaction structured to avoid the purposes of Section 1031(f). The Tax Court agreed, finding the transaction at issue no different from *Ocmulgee Fields* or *Teruya Brothers*. In other words, the Malulani Group and MBL were able to "cash out" of the investment in the Maryland property almost tax free. According to the court, the interposition of a qualified intermediary could not obscure that result.

Notably, the Tax Court concluded that the presence or absence of a prearranged plan to use property from a related person to complete a like-kind exchange is not dispositive of a violation of Section 1031(f)(4). Instead, the inquiry focuses on the actual tax consequences of the transaction to the taxpayer and the related party, considered in the aggregate, as compared to the hypothetical tax consequences of a direct sale of the relinquished property by the taxpayer. The court stressed that net tax savings achieved through use of the related party's net operating losses, as was the case in *Malulani Group*, may demonstrate the presence of a tax-avoidance purpose notwithstanding a lack of basis shifting.

Ltr. Rul. 201834010

Taxpayer partnership acquired two parcels of land (collectively, Property 1) and one parcel of land (Property 2), as replacement property in a direct like-kind exchange between Taxpayer and Affiliate (Initial Exchange). Affiliate is treated as a corporation for federal income tax purposes and was a "related person" to Taxpayer as that term is defined under Section 1031(f)(3).

Taxpayer will dispose of Property 1 as part of a second like-kind exchange (Second Exchange). The purpose of this transaction is to acquire further property as replacement property to be used as Taxpayer continues its trade or business. Taxpayer will not receive any cash or other non-like kind property in the Second Exchange. In addition, Taxpayer will dispose of Property 2 as a Code Section 721 contribution to an existing partnership (Contribution) solely in exchange for an additional interest, the value of which will equal the value of the property contributed, with no cash or other consideration received by Taxpayer.

Affiliate still owns all the property it acquired from Taxpayer in the Initial Exchange and, to Taxpayer's knowledge, Affiliate has no intent to dispose of the property. Furthermore, at the time of the Initial Exchange, Taxpayer did not intend, nor had a prearranged plan, to enter into the subsequent transactions discussed in this ruling.

Here, the acquisitions of replacement property by Taxpayer from Affiliate in the Initial Exchange would be followed by dispositions, within two years of the Initial Exchange, of the property in nonrecognition transactions. Taxpayer has represented that it will not receive any cash or other non-like-kind property in the Second Exchange. The IRS ruled that because both dispositions are in nonrecognition transactions and Taxpayer receives neither cash nor other consideration that would trigger gain in the dispositions, the dispositions are, under Section 1031(f)(2)(C), ignored in determining whether Section 1031(f) applies to require gain recognition in the Initial Exchange.

Swap and Drop

The rules applicable to exchanges involving partnerships were extensively discussed in "The 'State of the Art' in Like-Kind Exchanges, 2012."[23] Among those rules were a frequently encountered pair of questions relating to partnerships and Section 1031 transactions, whether (1) a taxpayer can exchange property in a distribution from a partnership (a "drop and swap"), and (2) whether a taxpayer who receives replacement property in an exchange can immediately transfer the property to a partnership (a "swap and drop"). Both transactions have been targeted by both the IRS and state tax authorities, but recently there has been some noteworthy developments at the state level relating to "swap and drop" transactions.

The main challenge that has been raised with respect to both transactions comes from the language of Section 1031(a)(1) which requires that both relinquished property and replacement property be *held* for productive use in a trade or business or for investment in a trade or business. In "The 'State of the Art' in Like-Kind Exchanges, 2012," we discussed various revenue rulings issued by the IRS attacking these transactions on this basis and how the IRS's attacks have been consistently rejected in cases like *Magneson,*[24] *Maloney,*[25] and *Bolker.*[26]

We also discussed the Tax Court's more recent decision in *Sandoval,*[27] where, in the Section 1033 context, the IRS had succeeded in challenging a transaction similar to a swap and drop, when the IRS's challenge had been based on a step-transaction argument. In "The 'State of the Art' in Like-Kind Exchanges, 2015," we discussed the background and analysis for the step-transaction argument.

We further noted how the saga of the swap and drop moved from the federal courts to the state courts, with most of the action focused in California. In two notable (although non-precedential) cases involving "swap and drop" transactions, *Appeal of Aries,* Appeal No. 464475, and *Appeal of Marcil,* Appeal No. 458832, the California State Board of Equalization (CSBE) sustained a taxable determination. However, in subsequent rulings, the CSBE seemed to change course with respect to swap and drop transactions, treating them as valid like-kind exchanges.

In *Aries,* a limited partnership that owned and operated apartments sold the apartments under threat of eminent domain. The partnership and its partners elected to defer capital gain realized on the sale under Section 1033(a)(2). As a replacement property, the partnership jointly purchased rental property along with three other parties. Immediately after the purchase, the parties contributed the property to a newly formed LLC. The California Franchise Tax Board (FTB) applied the step-transaction doctrine, determining that the partnership's interest in the rental property was "transitory" and that the partnership entered into the transaction with the intention of acquiring a membership interest in the LLC. By a 3-2 vote, the CSBE sustained the FTB's determination that the taxpayers' "swap and drop" transaction did not qualify under Sections 1031 and 1033.

In *Marcil,* the taxpayers, a husband and wife, were limited partners in a California limited partnership (HVA) that held the relinquished property that was transferred in exchange for replacement property. Eight days after the exchange, HVA assigned the property to the husband. The FTB determined that HVA failed to meet the "holding" requirement of Section 1031 and thereby effected a disqualifying "swap and drop" transaction. On appeal (by a 3-2 vote), the CSBE

18 580 F.3d 1038, 104 AFTR2d 2009-6274 (CA-9, 2009).

19 613 F.3d 1360, 106 AFTR2d 2010-5820 (CA-11, 2010).

20 779 F.3d 738, 115 AFTR2d 2015-993 (CA-8, 2015).

21 See Ltr. Rul. 201216007 and Ltr. Rul. 201220012, discussed in "The 'State of the Art' in Like-Kind Exchanges, 2015."

22 TCM 2016-209.

23 Note 1, *supra.*

24 753 F.2d 1490, 55 AFTR2d 85-911 (CA-9, 1985), *aff'g* 81 TC 767 (1983).

25 93 TC 89 (1989).

26 760 F.2d 1039, 56 AFTR2d 85-5121 (CA-9, 1985), *aff'g* 81 TC 782 (1983).

27 TCM 2000-189.

sustained the FTB position. However, the authors were informed by the attorney who represented the taxpayers in *Marcil* that the decision was reversed upon rehearing, whereupon the SBA issued a one-page decision stating that HVA had completed a valid exchange under Section 1031.[28]

Appeal of Rago Development Corporation, Appeal No. 735761 (6/23/2015)

This case appears to have confirmed the CSBE's changed course on the "swap and drop" fact pattern. Here, two parties exchanged their separate properties for joint interests in a common property. Seven months later, but in a subsequent tax year, the parties dropped the common property into a partnership. The parties did not have an agreement between one another to drop the property into a partnership; however, they did have an agreement with the bank providing purchase financing for the transaction requiring that the property be contributed to the partnership within a year. In a 5-0 decision, the CSBE upheld the taxpayer's treatment of the transaction as a valid like-kind exchange, rejecting the argument that the "held for" requirement was not satisfied and viewing the step-transaction doctrine as inapplicable.

Appeal of Giurbino, No. 861813 (11/29/2016)

The case concerned two taxpayers, a husband and wife, who were equal partners, along with a third individual, in a partnership that owned and operated a storage facility (Aim LLC). The facts of the case were a matter of controversy. The taxpayers claimed that Aim LLC had transferred its share of the storage facility to them before they engaged in a like-kind exchange. The FTB claimed that Aim LLC transferred the relinquished property and that the taxpayers received the replacement property. The FTB cited the Tax Court's opinion in *Chase*,[29] which held that an exchange did not satisfy the requirements of Section 1031 when a partnership was treated as the transferor of the relinquished property and the partners of the partnership received the replacement property:

> Section 1031(a) requires that like-kind property be both given up and received in the "exchange." Here, it is clear that [the partnership] transferred investment property but did not receive like-kind property in "exchange." This is because [the partnership] never held the properties that were ultimately received by petitioners as part of the purported "exchange." Accordingly, [the partnership] never "exchanged" like-kind property.

The Tax Court held that for a party to participate in an exchange, it must transfer the relinquished property and receive the replacement property. It is unclear why the Tax Court felt that it is important that the transferor party actually receive the replacement property (instead of, for example, directing receipt of the property to a different party). Indeed, as the taxpayers in *Giurbino* pointed out, when a party has a right to receive property and the party directs receipt of the property to another, the party is generally treated as receiving the property and transferring it to the other. Nevertheless, the CSBE followed *Chase*, invalidating the like-kind exchange on the grounds that Aim LLC transferred the storage facility, whereas, the partners of Aim LLC (the husband and wife) received the replacement property.

The taxpayer lost in *Giurbino*. However, the case appears to further support the CSBE's acceptance of swap and drop transactions as valid like-kind exchanges. Had Aim LLC received the replacement property, transferring it afterwards to the taxpayers, it appears that like-kind exchange treatment may have been upheld.

Giurbino serves as a caution for taxpayers considering a swap and drop to make sure to complete their "swap" before completing their "drop." In other words, when engaging in a swap and drop, make sure that the historic owner of the relinquished property both transfers the relinquished property and receives the replacement property ("the swap") before distributing the replacement property or contributing the replacement property to a separate taxpayer ("the drop").

A related point concerns transactions in which one partner wants to cash out while the other partners want to engage in a like-kind exchange. These transactions were discussed at length in several of the prior articles. Suffice it to say here that such transactions (including a drop and swap) continue to be possible, provided that the taxpayer actually engages in the transaction.

If a partnership wants to distribute a tenancy-in-common (TIC) interest to the cash-out partner, so that the other partners can engage in an exchange at the partnership level, it is most important that this distribution actually occur. Thus, there needs to be a transfer of a deed of the TIC interest to the cash out partner, which deed would ideally be recorded. Furthermore, if the property is subject to a loan, the lender's required consents needs to be obtained before the distribution of the TIC interest occurs. And the parties would need to enter into a TIC agreement that generally satisfies the requirements of Rev. Proc. 2002-22. So even a simple drop and swap transaction can require a lot of steps before it is implemented.

Like-Kind Exchanges Involving REITs

Like-kind exchanges can be valuable tools for real estate investment trusts (REITs) to avoid what are known as "prohibited transactions." In general concept, REITs are meant to be investment vehicles and generally are prohibited from carrying on activities that constitute an active business. Consistent with this theme, REITs are prohibited from holding property for sale in the ordinary course of business.[30] The penalty for violating this prohibition is that net gain from the sale of property sold by a REIT in the ordinary course of business is subject to a 100% tax. As a general matter, Section 1031(a) transactions are not sales in the ordinary course of business and are not subject to any prohibited transaction penalty except to the extent of any boot received in the exchange. However, another benefit of a like-kind exchange is the role that it plays in the prohibited transactions safe harbor, which is a statutory provision that, if satisfied by a REIT, prevents a sale from being treated as a sale in the ordinary course of business.[31]

Some of the safe harbor requirements are specific to the property sold. For example, the property must be held for the production of rental income for two years or more before it is sold. Other requirements look to the habits of the REIT. If a REIT sells more than seven properties in a year, to satisfy the safe harbor, the REIT is required to satisfy one of a number of tests that relate to the relative volume of property (by fair market value or by basis) sold over the course of the year or over a course of three years.

Conceivably, the IRS could argue that with respect to Section 1031(a) exchanges in which the REIT recognizes boot, the entire fair market value or basis of the property exchanged must be taken into account for the purpose of the relative volume tests. However, in Ltr. Rul. 200702021, the IRS privately ruled to the contrary that only the boot portion of the transaction must be taken into account. The IRS recently confirmed this position in Ltr. Rul. 201614009. Without formal guidance on the subject, this recent confirmation should help taxpayers get comfortable that only the boot portion of a like-kind exchange needs to be counted for the purpose of REITs' relative volume tests under the prohibited transactions safe harbor.

Another interesting matter raised in Ltr. Rul. 201614009 relates to the treatment of funds held by a QI between the sale of relinquished property and purchase of replacement property. For tax accounting purposes, these funds are treated either as owned by the exchanging taxpayer or as funds loaned by the exchanging taxpayer to the QI.[32] The funds are treated as owned by the taxpayer if the earnings attributable to the funds (e.g., bank interest) are paid to the taxpayer. The distinction between owning the funds and loaning the funds is particularly important for REITs because they are subject to asset and income tests that govern the types of assets they may own and the types of income they may earn.[33] For example, under Section 856(c)(4), at the close of every quarter, at least 75% of a REIT's assets must be "real estate assets, cash and cash items (including receivables), and Government securities." A loan receivable may not fall within this definition, but cash certainly would. Thus, in Ltr. Rul. 201614009, the taxpayer asked for and received comfort that the REIT would be treated as holding the cash proceeds from the sale of the relinquished property for the purpose of the asset test because the taxpayer was entitled to earnings attributable to such cash proceeds.

TCJA's Qualified Business Income Deduction and Like-Kind Exchanges

The TCJA also added Section 199A which provides a deduction of up to 20% of the "qualified business income" earned by a taxpayer directly or through certain pass-through entities. Generally, the deduction with respect to the qualified business income of a particular business is limited and cannot be greater than 50% of the wages paid to employees, or 25% of the wages paid to employees plus "2.5 percent of the unadjusted basis immediately after acquisition of all qualified property," whichever is greater (the "Section 199A Deduction Limitation").[34] Thus, even if a business pays little to no wages, it can still qualify for a deduction if it has sufficient tax basis in qualified property.

Only tangible, depreciable property can be qualified property. However, the basis of the property, for the purpose of determining the Section 199A Deduction Limitation, is generally the cost basis of the property, unreduced by depreciation (i.e., the unadjusted basis immediately after acquisition or "UBIA"). Property ceases to be qualified property after the lapse of its "depreciable period," which is the latter of: (1) ten years after the property was placed into service or (2) after the last day of the applicable recovery period for the property.[35]

After a like-kind exchange of qualified property, proposed regulations provide that a taxpayer's UBIA in replacement property is the taxpayer's basis in the relinquished property at the time of the exchange.[36] Thus, under the proposed regulations, a like-kind exchange generally would reduce a taxpayer's UBIA. In the absence of an exchange, the taxpayer's UBIA would remain its original cost basis in the qualified property. When the taxpayer exchanges its qualified property, UBIA would be reduced for depreciation in the qualified property between the time the taxpayer placed it in service and the time that the taxpayer exchanged it for replacement property. Thus, when it hurts the taxpayer to treat replacement property as new property, the proposed regulations treat the replacement property as new property.

On the other hand, when it helps the taxpayer to treat replacement property as new property, the proposed regulations generally do not treat the replacement property as new property. Specifically, in determining the depreciable period for the replacement property, the counting begins from the original acquisition of the relinquished property, unless the taxpayer elects to restart depreciation under Reg. 1.168(i)-6(i)(1).[37]

As of the date that this article was published, the proposed regulations have not been finalized. Furthermore, Treasury has taken under consideration whether it should allow taxpayers to retain the UBIA they had in the relinquished property in their replacement property, contrary to the current position of the proposed regulations.

Conclusion

As has been the case for decades, there is a continual stream of guidance from Treasury, the IRS, and the courts concerning like-kind exchanges. The major changes adopted in the TCJA will affect the world of Section 1031, but as long as exchanges of real property are permissible, it can be anticipated that taxpayers will want to engage in such exchanges. The most important questions concern the scope of "real property"; any guidance issued in that regard will be addressed in the next installment of "The 'State of the Art' in Like-Kind Exchanges."

NOTES

28 Email communication from the attorney for the taxpayers in the Appeal of Marcil, Layton L.Pace, dated 1/4/2016 (on file with authors).

29 92 TC 874 (1989).

30 Section 857(b)(6).

31 Section 857(b)(6)(C).

32 Reg. 1.468B-6(c).

33 Section 856(c).

34 Section 199A(b)(2).

35 Section 199A(b)(6)(B).

36 Prop. Reg. 1.199A-2(c)(3).

37 Prop. Reg. 1.199A-2(c)(2)(iii).