TULSA ESTATE PLANNING FORUM

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IRC §1031 EXCHANGES

Brief Overview

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IRC §1031 EXCHANGES

IRC §1031 "No gain or loss shall be 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 which is to be held either for productive use in a trade or business or for investment."

IRC §1031(f) related party restrictions may prevent the use of §1031 under certain circumstances when related parties are involved with the exchange.

Rev. Proc. 2000-37 refers to reverse exchanges as "Parking" arrangements. Prior authority used the term "Warehousing Exchanges" or "Construction Exchanges," both of which are within the meaning of a Parking Exchange under the Rev. Proc. Therefore, in these materials the term "Parking Exchange" will be intended to include either or both Warehousing Exchanges and Construction Exchanges.

Rev. Proc. 2002-22 refers to fractional interest programs where co-tenancies or undivided interests in real property are used as qualifying §1031 property. The revenue procedure is further elucidated by PLR 200513010.

I. Background and Overview of IRC §1031.

A. Advantages of Exchange.

Consolidation or Diversification of Investments

1. Appreciation - Leverage
2. Greater Cash Flow
3. Relocation of Investment
4. Exchange Out of Low-Basis Property Into Higher-Basis Property
5. Elimination or Reduction of Management Problems
6. Estate Planning Implications:
   - a. Die with the property - after §1031 exchanges
     - (1) Get "stepped-up" tax basis
     - (2) All built-in gain disappears
   - b. Gift the property before or after §1031 exchanges
     - (1) Avoid estate taxes (up to 40% in 2018).
     - (2) Appreciation is removed from taxpayer's taxable estate
     - (3) But, basis is "carried over" to beneficiary, not "stepped-up"
     - (4) Beneficiary pays the tax on built-in gain
     - (5) But, may have lower income tax bracket

B. Disadvantages.

1. Basis in Replacement Property is less than in a normal acquisition
2. Increase in Transactional Costs
3. Limits on Use of Property's Equity

C. The General Rule - IRC §1001. Gain or loss must be recognized on the disposition of property.

D. Exception - IRC §1031. Gain or loss is not recognized when property *held for productive use in trade or business*, or *for investment*, is exchanged for *like-kind property* to be held for productive use in trade or business, or for investment.

E. §1031 is to be Strictly Construed. Reg §1.1002-1(b) provides for the strict construction of exceptions to the general rule. The provisions of an exception do not extend beyond the words or the underlying assumptions and purposes of the exception.

II. Statutory Requirements For Tax-Free Exchanges.

A. IRC §1031(a)(1).

"No gain or loss shall be 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 which is to be held either for productive use in a trade or business or for investment."

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B. Exchange Requirement. An exchange requires a transfer of property for property as distinguished from a transfer of property for money or money's worth. The sale of a property followed by the purchase of qualifying property is not an exchange, even if that was the intent of the taxpayer. Intent is not dispositive on the question of whether an exchange occurred. (Bezdjian v. Comm., TC Memo 1987-140, affd 845 F2d 217 (CA9 1988)). Whether a sale and a reinvestment or an exchange occurs depends upon:

1. Whether there is contractual interdependence between the transaction disposing of the relinquished property and the transaction acquiring the relinquished property, and

2. Whether the taxpayer has constructively received the exchange proceeds. The essence of an exchange is the transfer of property for property; that of a sale is the receipt of cash or boot for property. The real issue is the receipt or constructive receipt of the cash (or other boot). This turns on whether there are substantial restrictions or limitations upon the taxpayers's access to the cash or boot as required by §451 to preclude constructive receipt.

C. Holding for a Qualified Purpose. The property is "held" for a qualified purpose if it is held by the taxpayer for either ***productive use in trade or business or for investment***. The holding period to satisfy the qualified purpose requirement is not specified under §1031 or the regulations. The regulations do not define this requirement. The term may have the same meaning as the term is used in IRC §§167 and 1231.

1. IRS takes the position that if the relinquished property was acquired immediately before the exchange, the taxpayer acquired the property primarily to dispose of it, rather than to "**hold** it for productive use in a trade or business or for investment."

2. Similarly, the IRS takes the position that if the replacement property is transferred immediately after the exchange, the property was not acquired for a "qualified" purpose. The IRS takes the position that "held for" requirement is not met if the property was acquired immediately before the exchange *Rev Rul* 84-121, 1984-1 CB 168. The IRS stipulated that 2 years was long enough, *Ltr Rul 8429039.*

3. Courts are much more liberal, however, looking at the facts and circumstances of the transfer - adding an element of "intent" to the holding period issue. The courts seem to look at the intent of the taxpayer on the reasons for the acquisition, and the shorter the time period the stronger the facts and circumstances must be to support the taxpayer's position. A number of courts have taken the same position, *Regals Realty Co. v. Comm.,* 127 F.2d 931 (CCA2 1942); *Griffin v. Comm.,* 49 TC 253 (1967). But other courts have been much more liberal in determining the holding period. In *Rutherford v. Comm.,* TC Memo 1978-505 the property was transferred immediately upon acquisition. That court applies a "facts and circumstances" test in determining if the "held for" requirement is met.

4. However, there is no safe holding period for property to automatically qualify it as having been held for a qualified purpose. (Ltr Rul 8429039 did say that a minimum two years holding period would be sufficient.)

5. In cases with shorter holding periods, courts have frequently ruled that the intent of the Taxpayer is most relevant to the issue of whether the Taxpayer's use of the property is a qualified use. To determine the intent of the Taxpayer at the time of the exchange, the courts apply the facts and circumstances standard.

a. This is a question of fact.

b. Determined at the time of the transaction.

c. Taxpayer has the burden of proof.

d. Minimal amounts of personal use do not necessarily taint the classification as §1031 property. (Ltr Rul 8103117)

D. "Like-Kind" Property.

1. **Real Property** - "like-kind" refers to the nature or character of the property and not to the grade or quality. The following characteristics refer only to *grade or quality*, and **not** to *nature or character* of the property, and are therefore not relevant to determining whether the property is "like-kind":

a. Whether the real estate is improved or not improved is immaterial.

b. City real estate may be exchanged for ranch or farm real estate.

c. Multi-family, commercial, single-family (rental), office, industrial, etc. are all like-kind,

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being only differences in grade or quality, not nature or character.

d. A leasehold with 30 years or more (or with optional renewal periods) to run may be exchanged for a fee interest in real estate.

2. **Personal Property**. The 2017 Tax Cuts and Jobs Act ("TCJA") eliminated personal property as a qualified property for the application of Section 1031 exchange treatment.

a. In light of the increased and expanded expensing under Code Sec. 168(k) and Code Sec. 179, which raises the pre-inflation adjusted dollar limit to $1million from $500k and the beginning phase down threshold to $2.5 million from $ million, for tangible personal property and certain building improvements, Congress believed that §1031 should be limited to exchanges of real property not held primarily for sale.

b. Thus, exchanges of machinery, equipment, vehicles, patents and other intellectual property, artwork, collectibles, and other intangible business assets do not qualify for nonrecognition of gain or loss as like-kind exchanges. The affect was the elimination of Rev Proc 2003-39 LKE Programs for mass assets such as master exchange programs for rolling stock of vehicles and equipment leasing companies, railroads and aircraft leasing companies.

E. Unfinished Property.

1. **Real Property.** Improvements to Real Property need not be completed in order for Real Property to qualify under §1031. However, the improvements to real estate which are made after the Taxpayer has acquired the replacement property do not qualify as "like-kind" replacement property. (*Bloomington Coca-Cola Bottling Co. v. Comm*., 189 F2d 14 (CA7 1951); Reg §1.1031(k)-1(e)(4).) Therefore, the value of property will be determined as of the point of completion that existed when sold as relinquished property of acquired as replacement property.

a. However, improvements which are substantially completed by a third party (who is not a "disqualified person," prior to the date that the Taxpayer receives the replacement property) can be included in the valuation of the replacement property.

b. Planned improvements to real estate do not need to be totally completed in order for the exchange to get the benefits of §1031, for valuation purposes only those improvement that have been completed can be considered for valuation purposes. This will necessitate the use of a Construction Reverse Exchange, where a third party acquires the real estate and constructs the improvements before the Taxpayer takes title.

F. Dealer Property.

1. Real property can be dealer property. When the gain on the property is taxed as ordinary income it is dealer property and will not qualify under §1031, *Margolis v. Comm.,* 337 F.2d 1001 (CA9 1964).

G. Property Held Primarily for Sale. Property held "primarily" for sale also will not qualify under §1031 even though it is not inventory for sale in the ordinary course of business. "Primarily" means of first importance, *Malat v. Riddell*, 383 US 569, 5. L.Ed2d 154, 86 S.Ct. 244 (1966).

1. The fact that the property is held as a capital asset does not ensure that the property will qualify under §1031.

2. In *Neal T. Baker Enterprises, Inc.*, TC Memo 1998-302, the court held that real estate was held primarily for resale, even though the taxpayer held property for 11 years and never put improvements on the property, because the taxpayer held the property on his books as "work in progress."

3. The use of the property while it is held, the purpose or which the property is held, and facts surrounding the exchange, the are factors to be considered. *Bernard v. Comm.,* TC Memo 1967-176.

III. <u>Deferred Exchanges Under the Regulations</u>.

A. Published by the Treasury Department on May 1, 1991. Adopted a liberal approach to deferred exchanges.

1. Created a mechanical process for identifying and receiving replacement property, and revoking such identifications

2. Provided special rules for identification of property to be produced

3. Addressed multiple relinquished and replacement properties

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4. Defined the identification period and the exchange period

5. Provided for disregarding incidental property

6. Created four (4) important Safe Harbors to avoid actual or constructive receipt of the proceeds

a. Can secure the taxpayer's funds and the obligation of the transferee of the relinquished property to acquire replacement property

b. Established the rules for Qualified Escrow Accounts and Qualified Trusts

c. Established the "Qualified Intermediary" concept

d. Allowed interest on the proceeds for the taxpayer's benefit

B. Identification and Receipt Requirements. If the identification and receipt requirements are not strictly followed, the exchange will be disallowed.

1. **Time Frames**. If the requirements of §1031(a)(3) for the 45-day identification period and 180-day exchange period are not met, the exchange will be disallowed.

a. The regulations provide that the time requirements are absolute. There are no exceptions.

b. These periods commence on the date of the transfers. Property is transferred under §1031 when it is disposed of within the meaning of §1001(a) or receipt occurs with the transfer of the benefits and burdens of the property.

c. The identification period and the exchange period for Multiple Relinquished Properties that close on different days will commence on the closing of the earliest transaction.

2. **The Replacement Property Identification**.

a. In writing - faxed, hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period

(1) To the seller of the replacement property, or

(2) To any other person involved, other than the taxpayer or disqualified person

b. Actual closing and receipt of the replacement property within the identification period constitutes an identification, and no written identification is required.

c. Identification of the replacement property made by a written exchange agreement entered into within the identification period constitutes an identification.

3. **Number of Properties Identified**.

a. **Three Property Rule**. Three properties, without regard to the fair market value of the properties, or

b. **Two Hundred Percent Rule.** Any number of properties, so long as their aggregate fair market value at the end of the identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties, as of the date other relinquished properties were transferred

c. **Ninety-five Percent Rule.** Any number of properties, so long as 95% of all the properties identified are actually acquired in the exchange

4. **Consequences of Violating the Multiple Property Identification Rules**. The taxpayer will be deemed not to have identified any properties.

5. **Revocation of Identification**. Identification may be revoked at any time within the identification period.

a. In writing, signed by the taxpayer

b. Delivered in a manner permitted for the delivery of the identification

IV. <u>Safe Harbor No. 3-Qualified Intermediaries</u>.

A qualified intermediary is not considered to be the agent of the taxpayer for purposes of §1031 exchanges.

A. **The Non-agency Fiction.** This is a fiction established by the Regulations. It is immaterial that the intermediary would be an agent under the general rules of agency.

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B. **The "G6" Requirements.** The intermediary agreement must expressly limit the rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. (Reg §1.1031(k)-1(g)(4)(ii). The Safe Harbor ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the intermediary. Rights under state law to dismiss the intermediary are ignored for this purpose.

C. **A Qualified Intermediary**...

1. Cannot be the taxpayer.

2. Cannot be a "disqualified person" (see the definition below).

3. Must enter into a written agreement with the taxpayer.

4. Is deemed to have acquired the relinquished property from the taxpayer and transferred the property to the buyer if the sale contract is assigned to the intermediary and notice of the assignment is given to the buyer.

5. Is deemed to have acquired the replacement property from the seller and transferred the property to the taxpayer if the sale contract is assigned to the intermediary and notice of the assignment is given to the seller.

D. **Direct Deeding**. The Qualified Intermediary is the only Safe Harbor that can use direct deeding.

V. <u>Release of the Exchange Funds to Taxpayer</u>.
The agreement may provide for the delivery of the exchange funds to the taxpayer. Reg 1.1031(k)-1(g)(6).

A. Should properties not be identified - gain will be recognized.

B. After the receipt of all the identified properties - gain will be recognized at least to the extent of the amount released.

C. The occurrence after the end of the identification period of a material and substantial contingency that relates to the deferred exchange, which is beyond control of the taxpayer or any disqualified person - gain will be recognized at least to the extent of the amount released.

D. The IRS has ruled that even if no replacement properties have been purchased, the Intermediary Agreement cannot be rescinded by general contract law and exchange funds returned early, if taxpayer and intermediary desire to cancel the agreement.

VI. <u>Reverse Exchange Defined</u>.

If the Taxpayer causes the replacement property to be closed before closing on the disposition of the relinquished property, the transaction is a reverse exchange. A "true" reverse exchange happens when the Taxpayer actually takes title to the replacement property, either individually or through an agent, but under circumstances permitted by the case law so as to preserve the exchange requirements. "Parking" exchanges are the more common form of reverse exchange. There, a Qualified Intermediary will purchase the replacement property and "park" the property until it is needed, then it will participate as the Seller of the relinquished property in a forward exchange with the Taxpayer. The "Parking" exchange is the subject of Rev. Proc. 2000-37. A reverse "parking" exchange is useful in the following situations:

A. Construction Exchanges. Use when the Taxpayer wants to acquire a property after new improvements have been constructed (i.e., tenant finishes, major repairs, or the entire construction of new buildings) and before the Taxpayer takes title. As mentioned above, this must be done if the improvements are to be included in the exchange for valuation purposes.

1. This is also useful when the Taxpayer wants to use part of the cash proceeds from the sale of the relinquished property to construct the improvements on the replacement property. By doing a Construction Exchange, the improvements can be made by the construction intermediary and the property then sold at a higher valuation, thus consuming the cash from the relinquished property that was budgeted to make the improvements. Doing otherwise will cause the budgeted cash to be taxable "boot" on the sale of the relinquished property.

2. This necessitates the use of a Qualified Intermediary to acquire and "park" the title to the replacement property and to make the improvements on the property before the Taxpayer accepts title with the completion of the exchange.

B. Warehousing Exchanges. Replacement properties that are already suitable for acquisition may need to be acquired before the Taxpayer is able to close

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his relinquished property. Taxpayers have used warehousing exchanges to acquire replacement property before even deciding which property they want to sell (however, great care should be used in structuring such an exchange because of the requirement that the sale and the acquisition be part of an integrated transaction, and that the intermediary have all the tax benefits and burdens during the holding period.) Thus, a Qualified Intermediary must be used to acquire and "park" the property until the relinquished property can be closed.

1. Use when Taxpayer cannot close the relinquished property before having to acquire the replacement property;

2. Use when contingencies on the sale are delaying the closing of the relinquished property and the acquisition of the replacement property will be jeopardized by waiting;

3. Use when a Buyer has not been found for the relinquished property;

4. Use when Taxpayer's earnest money is at risk for not closing;

5. Use when Taxpayer's favorable mortgage rate is jeopardized by a wait;

6. Use when there is not adequate time within the 180-day forward exchange period to complete the construction of improvements by the intermediary. If the construction period will exceed 180 days, the replacement property must be acquired before the sale of the relinquished property so enough time is available for the construction. (Note, this would also cause the exchange to be outside the requirements of Rev. Proc. 2000-37 because of its separate 180 day requirement).

VII. General Authority for Reverse Exchanges and Rev. Proc. 2000-37.

Reverse exchanges are not specifically authorized by IRC §1031(a)(3), or the Reg §1.1031.

A. Rev. Proc. 2000-37. Revenue Procedures are not law. They can be overturned by courts and voided by the IRS at its mere whim (though this is highly unlikely, since reverse exchanges have been "under study" by the IRS since 1991).

1. Rev. Proc. 2000-37, issued on September 15, 2000, has given the first inclination that the IRS believes there is a legal foundation for reverse exchanges, by giving a Safe Harbor for their use (provided they are structured exactly as described in the Rev. Proc..)

2. Rev. Proc. 2000-37 lends great comfort to practitioners who have been doing reverse exchanges for the last 20 years. It endorses the fact that the IRS believes there are legal grounds for their use, but the Rev. Proc. is only applicable to the exact factual circumstances set forth in the Rev. Proc.

3. It specifically states that reverse exchanges not done exactly as prescribed will not get the benefit of the "Safe Harbor."

4. It also states that a reverse exchange that fails to be within the requirements of the Rev. Proc. will not be prejudiced by this failure, if it is otherwise a valid reverse exchange.

5. This leads us to believe that the IRS is uncertain about the law in general, and that it believes there are other methods not conforming to the Rev. Proc. that are valid. This is important because not all reverse exchanges can be structured to comply with the Rev. Proc.

B. The Statute, the Regulations. When the order of the sale of the relinquished property and the acquisition of the replacement property must be reversed, issues relate to whether the intermediary is acting as the Taxpayer's agent in the acquisition and holding of the replacement property, which occurs before the Taxpayer sells the relinquished property. If so, the Taxpayer would be in constructive receipt of the replacement property and would not comply with the Exchange Requirement. It would be a purchase independent from the sale. Rev. Proc. 2000-37 creates a fiction by deeming the qualified intermediary not to be the agent of the Taxpayer, thus solving the constructive receipt problems. But, what if the reverse exchange is outside the applicable requirements of the Rev. Proc.?

1. **Constructive Receipt Issues, Non-Rev. Proc. Exchanges**.

a. There are significant agency issues.

b. If the intermediary is an agent of the Taxpayer, then the acquisition by the intermediary will be deemed the acquisition by the Taxpayer, and the Exchange Requirement would be violated.

c. If the IRS is successful in arguing constructive receipt, the sale of the relinquished

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property will be currently taxed and not deferred under §1031.

2. **IRC §1031(a)(3).** Reverse exchanges do not conform literally to the "Safe Harbors" of Treas. Reg. §1.1031, but IRC §1031(a)(3) may apply.

a. Problems of reverse exchanges are similar to the constructive receipt problem which existed prior to the *Starker* case with deferred exchanges.

b. In *Starker*, §1031(a)(3) was held to apply regarding the constructive receipt issue, though the statute is silent on the issue. §1031(a)(3) might also be interpreted to avoid constructive receipt in reverse exchanges.

c. There is no express requirement of the statute for the order of the relinquished property and the replacement property transactions, just as there was not an express provision preventing deferred exchanges.

d. If §1031(a)(3) applies, the Regulations state that the intermediary *is not the agent of the Taxpayer.*

VIII. Revenue Procedure 2000-37

A. IRS's Decision to Issue the Rev. Proc. According to the author of the Revenue Procedure, one of the purposes of publishing the procedure was to change the implied effect of an earlier Technical Advisory Memorandum (TAM 200039005). Had the TAM not implied that "parking" exchanges do not qualify as §1031 exchanges, the IRS would not have decided to undertake the publication of the procedure.

B. TAM 200039005. The TAM said that the intermediary was the *agent* of the Taxpayer in a "true" exchange because the intermediary was the nominee of the Taxpayer, the Taxpayer negotiated the purchase, provided the funds for the purchase, and was personally liable for the bank loan to the intermediary to acquire the property. The IRS concluded that the agent, was effectively the Taxpayer when it bought the replacement property. The TAM seemed to imply that it was the "agency" issue that caused the exchange to fail. But a closer examination of the TAM reveals that the ruling, in reality, could have been based on the fact that the purchase of the replacement property was determined not to be an *integrated transaction* with the sale of the relinquished property. The Rev. Proc. confirms that the TAM conclusions about agency were erroneous. In fact, the determination of agency is a matter of case law, and the factors recited by the IRS in the TAM would not alone have caused the intermediary to be the agent of the Taxpayer. Case law looks to the benefits and burdens issue instead. So the TAM should not give us concern when applying the Rev. Proc. or when we otherwise proceed under the case law.

C. Analysis Of QEAA Safe Harbor Under Rev. Proc. 2000-37.

1. **Availability.** The Safe Harbor may not be available in many situations in which reverse exchanges or "parking" transactions are used.

2. **Tax Certainty.** For those cases where the Safe Harbor can be used it will be possible to achieve tax certainty for reverse exchanges.

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