

# **SUMMARY OF RECENT DEVELOPMENTS UNDER SECTION 1031**

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## Overview

This summary of recent Section 1031 developments covers regulations, rulings and cases from May 2001 through April 2002. Perhaps the biggest development is Rev. Proc. 2002-22, 2002-14 I.R.B. 1 (3/19/02) in which the IRS provided guidelines for ruling requests on tenancy-in-common interests in rental real estate. A major portion of this year's NRDC Conference is devoted to undivided fractional interests ("UFIs"). Final regulations expanded the exception to the definition of a "disqualified person" under Reg. Section 1.1031(k)-1(k) to include bank affiliates as well as banks. T.D. 8982 (2/1/02). A private letter ruling (PLR) held that an express agency statement to prevent duplicate transfer taxes will not adversely affect a qualified exchange accommodation agreement under Rev. Proc. 2000-37, 2000-40 I.R.B. 308. In the ruling, the agreement stated that the exchange accommodation titleholder (EAT) "is acting solely as [Customer's] agent for all purposes except for federal income tax purposes." PLR 200148042 (8/29/01). The implications of these developments are discussed in detail below.

Three cases were decided involving Section 1031. The first addressed Reg. Section 1.1031(k)-1(j)(2). The court held that the taxpayer had a bona fide intent to enter into a deferred exchange at the beginning of the exchange period and qualified for installment sale reporting. The court held that the taxpayer was not in actual or constructive receipt of property during the tax year in question, even though the property received in the next tax year (fee interests in timberland) was probably not of like kind to the relinquished property (2-year timber cutting rights). Smalley v. Commissioner, 116 T.C. No. 29 (6/14/01). The Smalley case and the bona

fide intent test are analyzed below.

The second case is straightforward and involved a partner's failure to report his distributive share of a partnership's gain on a Section 1031 exchange. The partner's distributive share of the gain is taxable to the partner irrespective of whether the income is actually distributed to him. In this case, the partnership reinvested all of the sales proceeds in like-kind property but presumably traded down in value and had to recognize gain on the exchange. Charma v. Commissioner, T.C. Memo 2001-253 (9/24/01) .

The third case is Bundren v. Commissioner, \_\_\_\_ F.3d \_\_\_\_ (10<sup>th</sup> Cir. 2002), aff g T.C. Memo 2001-2. The Tax Court's decision was discussed last year and held that the taxpayer's basis at the time of the conversion of a personal residence to rental property was its fair market value since that amount was less than the cost basis. The IRS determined and the Tax Court found that the fair market value of the relinquished property was \$134,500 at the time of the conversion in September 1994, which was the price at which the taxpayer exchanged it in December 1994. On appeal, the taxpayer claimed that the IRS's determination of fair market value was incorrect because it failed to take into account the taxpayer's pressure to sell the property due to its unsuitability as rental property and his own cash crunch. The taxpayer argued for a value of \$200,000 or more but presented no evidence and failed to prove that the IRS's determination was erroneous. Accordingly, the Tenth Circuit affirmed the Tax Court. The surprising aspect of this case is that the parties stipulated that the transaction qualified as a Section 1031 exchange. As a result, no one, not even the Tenth Circuit, questioned the short

holding period as rental property (approximately 4 months) before the exchange.

The IRS issued further guidance on related party exchanges. In a technical advice memorandum (TAM), the IRS ruled that Section 1031(f)(4) applies if a related party sells the replacement property to the taxpayer's intermediary in a simultaneous exchange. The taxpayer's exchange is taxable under Section 1031(f)(4), notwithstanding the taxpayer's business reasons for the transaction. TAM 200126007 (3/22/01). In a field service advice (FSA), the IRS clarified that a disposition of property more than 2 years after an exchange with a related party will not trigger recognition of gain under either Section 1031(f)(1) or Section 1031(f)(4), even if the parties plan to dispose of the property after the two-year holding period. FSA 200137003 (5/10/01).

The IRS ruled that the qualified intermediary (QI) safe harbor rules are "specific and exact." In the ruling, the taxpayer could not prove compliance with the requirements for either (i) written notice of the assignment of the relinquished property contract to the purchaser under Reg. Section 1.1031(k)-(g)(4)(v), or (ii) an exchange agreement that contained express limitations on the taxpayer's rights to receive money or other property under Reg. Section 1.1031(k)-1(g)(6). As a result, the intermediary was deemed to be the taxpayer's agent, and the exchange was considered taxable. TAM 200130001 (3/1/01). The IRS also held that the 180-day exchange period is a strict deadline. The 180-day period under Section 1031(a)(3)(B) is not suspended under Section 6503(b) even though the exchange funds are held as part of a receivership proceeding against a QI. PLR 200211016 (12/10/01).

An interesting ruling was issued concerning an exchange of undivided interests in electric generation plants. The ruling addressed Section 1060, the multiple property exchange regulations, and “contingent” liabilities associated with decommissioning the plants. PLR 200208004 (11/9/01). Our analysis of the ruling focuses on the treatment of the decommissioning liabilities assumed in the exchange. A field service advice analyzed a lease-in, lease-out (LILO) arrangement entered into to avoid recognition of gain on an exchange. The IRS found the LILO arrangement to be a sham using an economic substance analysis. The IRS also noted that the replacement property may be an excluded partnership interest under Section 1031(a)(2)(D). FSA 200205023 (10/24/01).

Other rulings involved disregarded entities. In PLR 200118023 (1/31/01), a QI formed a single-member LLC to acquire replacement property, construct improvements and transfer the ownership interest in the LLC to avoid transfer tax. In PLR 200131014 (5/2/01), the IRS ruled that a post-exchange transfer to a single-member LLC will not violate the holding requirement. In PLR 200151017 (9/17/01), the IRS held that a statutory merger of subsidiaries before the QI transferred the replacement property did not qualify the exchange.

Finally, various rulings addressed the like-kind requirements. In PLR 200137032 (6/15/01), the IRS ruled that the conversion of ownership in a New York cooperative for a condominium interest in the same unit qualified under Section 1031. Three private letter rulings involving the same facts found that a perpetual conservation easement was of like kind to a fee interest. PLRs 2002010007, 200203033 and 200203042. A ruling under Section 1033 merely

cross-referenced Section 1031 for purposes of determining like-kind property. PLR 200145001 (11/9/01). The Smalley case and PLRs 20013014 and 200208004 also had like-kind issues.

A copy of the regulations, cases and rulings is enclosed with the program materials. Here we discuss the highlights by subject area, referencing prior cases and rulings to illustrate the background and trends in the law. These recent developments are analyzed under the following topics:

1. Undivided Fractional Interests (UFIs);
2. Qualified Intermediaries (QIs), Exchange Accommodation Titleholders (EAT), and Agency;
3. Installment Sales and the Bona Fide Intent Requirement;
4. Related Party Exchanges;
5. Multiple Property Exchanges and Contingent Liabilities;
6. Leasehold Interests;
7. Disregarded Entities; and
8. Like-Kind Property.

### **Undivided Fractional Interests (UFIs)**

In Rev. Rul. 2002-22, 2002-14 I.R.B.1 (March 19, 2002), the IRS issued long-awaited guidance on UFIs, also known as co-ownership or tenancy-in-common interests (TICs). Rev. Proc. 2002-22 specifies the conditions under which the IRS will consider a request for a ruling

that a UFI in rental real property (other than mineral property) is not an interest in a partnership (or other business entity) for federal income tax purposes. Although such a ruling may be useful for a variety of tax purposes, it is very valuable for purposes of Section 1031. If a UFI will be transferred as relinquished property or received as replacement property in an exchange, such a ruling would ensure that the UFI is not treated as a partnership interest under Section 1031(a)(2)(D) or as stock in a corporation under Section 1031(a)(2)(B), both of which are excluded from the provisions of Section 1031.

Section 3 of Rev. Proc. 2002-22 states that “the guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.” Notwithstanding this “no inference” language, the cases, rules and principles noted in the revenue procedure indicate the IRS’s position on sponsored UFI arrangements. A “sponsor” is defined in the revenue procedure as any person who divides a single interest in property into multiple co-ownership interests for the purpose of offering those interests for sale. The same principles have implications for traditional UFI arrangements, including simple co-ownership of rental property without a sponsor, manager, broker or single tenant. The more a UFI arrangement departs from satisfying the 15 conditions specified in the revenue procedure, the more likely it seems that the IRS will reclassify a UFI arrangement to be a tax partnership. Failure to meet some of these conditions should be fatal as a matter of substantive law (e.g., holding title in an entity, filing partnership returns, engaging in an active business), while failing to satisfy other conditions may not be determinative (e.g., having more than 35 co-owners, disproportionate sharing of debt, having more extensive co-ownership, management or lease agreements).

Rev. Proc. 2002-22 may require tax opinions on UFI arrangements to address whether or not the arrangement will qualify for an advance ruling. Although Rev. Proc. 2002-22 does not change the law applicable to co-ownerships and partnerships, an opinion should not simply disregard it. If the UFI arrangement meets the conditions for an advance ruling, that would certainly make it more likely that the IRS would not recharacterize the arrangement as a partnership. Conversely, if a UFI arrangement will not qualify for an advance ruling, an investor should know that fact and be advised of the risks of reclassification. Similarly, disclosures should be made to prospective investors by sponsors and brokers that a UFI arrangement is ineligible for an advance ruling or that no such ruling will be sought. Such disclosures may be necessary to ensure full compliance with securities and real estate disclosure laws. These disclosures may parallel those customarily made in connection with limited partnerships which were at risk of being recharacterized as an association taxable as a corporation before the entity classification rules were simplified.

Rev. Proc. 2002-22 may also demand reconsideration of existing UFI arrangements in an attempt to satisfy, or come closer to satisfying, the conditions for an advance ruling. This would reduce tax risks and may provide a marketing advantage to sponsors of UFI arrangements that receive a favorable advance ruling or that are “ruling eligible.” All other things being equal, UFI arrangements that do not receive an advance ruling or are not “ruling eligible” may be at a competitive disadvantage. The revenue procedure could spawn a new acronym for marketing UFI investments: “RETICs” or “ruling eligible” tenancy-in-common interests.

Rev. Proc. 2002-22 falls short of meeting the most hopeful expectations of sponsors of UFI arrangements. It imposes conditions that may be undesirable, impractical or impossible to meet, including the limitations imposed on a co-ownership agreement, the limitation on the number of investors to no more than 35 persons (husband and wife and heirs are treated as a single person), the requirement that all debt be proportional to a co-owner's interest, and the desired compensation and ongoing rights of sponsors and their affiliates. In particular, enhanced returns to program sponsors through higher sales prices, equity participation, master leases and similar arrangements are not permitted if they exceed fair market value or depend, in whole or in part, on the income or profits of any person from the property. This condition alone may kill any thought of obtaining a ruling.

The revenue procedure also does not create any safe harbors blessing certain kinds of UFI arrangements. It merely signifies that the IRS may consider a favorable ruling if all of the required information is provided (see Section 5) and all of the conditions are met (see Section 6). Section 6 of the revenue procedure states: "The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate." Section 4 cautions, however, that even if all of the conditions are met, "the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration." All of these caveats may make any claim of "ruling

eligible” status imprudent or specious. Only if a ruling is in fact obtained would taxpayers have some certainty. And the IRS’s approach to rulings under the revenue procedure may be conservative so that only “vanilla programs” are approved.

**Background.** Rev. Proc. 2002-22 supersedes Rev. Proc. 2000-46, 2000-44 I.R.B. 438, which amplified the “no ruling” list by adding UFIs. In Rev. Proc. 2000-46, the IRS indicated that it was studying UFI arrangements and requested comments on (1) the terms of any leasing or management agreements and the relationships between the parties and the sponsor; (2) the terms of any agreements between the sponsor and holders of UFIs or among the holders of UFIs, including contractual restrictions to which the UFIs are subject, such as waivers of the right to partition, rights of first refusal and options to put and/or call the UFI; and (3) the overall economics of the arrangements, including the sharing of profits and losses from the operation of the property as well as appreciation and depreciation in the value of the property.

Rev. Proc. 2000-46 was issued in response to private letter ruling requests to approve exchanges of UFIs in net leased real property. In such arrangements, the co-owners may master lease the replacement property to the sponsor or an affiliate on a triple net basis for a significant term. The arrangements vary but sponsors or their affiliates are involved, and they typically lease or manage the property and earn more than just a real estate commission on the deal. Such arrangements usually include a net lease and a passive role assumed by holders of the UFIs (akin to clipping a bond coupon each month). At the end of the lease term, the co-owners may have the right to possess the property or this right may be subject to an option to purchase. During the

lease, the master lessee pays all taxes, insurance, operating expenses and maintenance as additional rent. The master lessee also pays a stated base rent to the co-owners. The master lessee may pay any principal and interest payments to a co-owner's lender upon request, with the net amount going to the co-owner. The master lessee subleases the property to tenants that it selects. Any rent increases or decreases under the master lease are fixed and not related to the subleases or the profitability of the property. Transfer of the UFI's may or may not be subject to contractual restrictions, such as waiver of the right to partition, rights of first refusal and options.

Rev. Proc. 2000-46 was greeted by the tax community as a favorable sign that the IRS might bless sponsored UFI arrangements through a safe harbor. But Rev. Proc. 2002-22 is very limited, does not create any safe harbor, and does not provide any real certainty to taxpayers except those who in fact obtain an advance ruling. Section 2 of Rev. Proc. 2002-22 contains a detailed discussion of the applicable regulations which are broad in scope in defining a partnership for federal income tax purposes. Section 2 also cites some of the rulings and cases that are relevant to determine whether a sponsored UFI arrangement is a tax partnership.

**Authorities.** Reg. Section 301.7701-1(a)(2) provides that a joint undertaking or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide the profits therefrom. This determination is made as a matter of federal tax law and does not depend on whether the arrangement is recognized as an entity under local law. If the arrangement creates a business entity with two or more members, the entity will be classified as a partnership or corporation.

See also Reg. Section 1.761-1(a) broadly defining a tax partnership. An exchange into or out of an interest in such a tax entity would not qualify under Section 1031. Sections 1031(a)(2)(B) and (D) exclude stock and partnership interests from nonrecognition treatment under Section 1031.

The IRS pointed out that, under common law, the central characteristic of a tenancy in common is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. A tenant in common has the benefits of direct ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common.

The IRS discussed Rev. Rul. 75-374, 1975-2 C.B. 261. Rev. Rul. 75-374 held that a two-person co-ownership of an apartment building did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owner employed an agent to manage the apartments on their behalf. The agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditions, trash removal, unattended parking, and maintenance of public areas. The ruling concluded that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. The IRS also cited Rev. Rul. 79-77, 1979-1 C.B. 448, which did not find a business entity where three individuals transferred ownership of a commercial building

subject to a net lease to a trust with the three individuals as beneficiaries.

Then the IRS analyzed the cases that specifically address sponsored UFI arrangements. Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the IRS noted that the courts have looked at the relationships not only among the co-owners, but also between the sponsor and the co-owners in determining whether the co-ownership gives rise to a partnership. The IRS cited Bergford v. Commissioner, 12 F.3d 166 (9<sup>th</sup> Cir. 1993) in which seventy-eight investors purchased “co-ownership” interests in computer equipment that was subject to a 7-year net lease. The co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment’s selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager’s consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court’s decision were the limitations on the co-owners’ ability to sell, lease, or encumber either the co-ownership interest or the underlying

property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford, 12 F.3d at 169-180. See also Bussing v. Commissioner, 88 T.C. 449 (1987), aff'd on reh'g, 89 T.C. 1050 (1987); Alhouse v. Commissioner, T.C. Memo 1991-652.

Under Reg. Sections 1.761-1(a) and 301.7701-1 through 301-7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, the IRS warned that "a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. Bergford, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Bussing, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. Bergford, 12 F.2d at 169." But these statements do not provide "bright line" tests and the dividing line between co-ownerships and partnerships remains unclear.

As a matter of federal tax law, no one can say with great assurance that a sponsored UFI arrangement is not a tax partnership. The answer may depend upon the exact terms of the such arrangements. Is there a trade, business, financial operation or venture? If so, who carries it on?

Should the activities of the sponsor, manager or lessee be attributed to the holders of the UFI's?

Are any "additional services" provided to tenants? Is there a sharing of profits and losses or other shared economic interest between the lessors and lessee or owners and manager? See, e.g., Bergford, supra; Bussing, supra; PLR 8330093; PLR 8046064. Simply because they are sponsored, should sponsored UFI arrangements be treated differently than traditional co-ownership of property that has long been recognized as not creating a separate entity for tax purposes? See Estate of Appleby v. Commissioner, 41 B.T.A. 18 (1940), affd 123 F.2d 700 (2d Cir. 1941); Gilford v. Commissioner, 210 F.2d 735 (2d Cir. 1953); Powell v. Commissioner, T.C. Memo 1967-32; McShaine v. Commissioner, 68 T.C. 154 (1977).

**Securities?** Rev. Proc. 2002-22 only addresses whether UFI's are interests in a separate tax entity (and thus constitute excluded property as stock or a partnership interest). It does not implicate the separate question of whether the exclusion under Section 1031(a)(2)(C) for "other securities or evidences of indebtedness or interest" should apply to sponsored UFI's. Sponsored UFI's might not be interests in separate tax entities and still be disqualified as a "security" under Section 1031. It was reported that the staff of the Securities and Exchange Commission, which has no jurisdiction over the issue under Section 1031, views UFI's as "securities" within the meaning of Section 2(a)(1) of the Securities Act of 1933 (1933 Act). See report from SEC Today, August 30, 2000 (Volume 2000-167), citing SEC No-Action Letter Ind. & Summaries (August 23, 2000). The report states that, without elaboration, the staff of the SEC disagreed with a promoter's view that the UFI's at issue were not "securities" under the 1933 Act. Accordingly, the staff was unable to ensure that it would not recommend enforcement action

unless the offer and sale of the UFIs were registered under the 1933 Act or were exempt from registration. There is no definitive authority on what constitutes “other securities” for purposes of Section 1031(a)(2)(C). But a final determination that UFIs are “securities” under the 1933 Act could also be fatal under Section 1031(a)(2)(C).

The 1933 Act includes in the definition of a “security” such things as any “participation in any profit-sharing agreement,” “investment contract,” “transferable share,” “fractional undivided interest in oil, gas, or mineral rights,” or in general “any interest or instrument commonly known as a ‘security’.” Compare Estate of Meyer v. Commissioner, 59 T.C. 311 (1972) (propriety partnership interests in rental real estate were not “investment securities,” “choses in action” or similar intangibles excluded from Section 1031). Meyer was decided prior to the enactment of Section 1031(a)(2)(D) in 1984. But it contains a discussion of excluded property under Section 1031 and the reasons for the change in law in 1923 (when stocks, bonds, notes, securities, choses in action, etc., were excluded from the predecessor provision to Section 1031).

**Conditions for Ruling.** Section 5 of the revenue procedure outlines the information required as part of a ruling request. The request must contain a complete statement of all facts relating to the UFI arrangements, including those relating to promoting, financing, and managing the property. The information must include all promotional documents relating to the sale of the UFI, and all agreements relating to the property, including lending, co-ownership, lease, purchase and sale, management, brokerage, indemnity, guaranty and option agreements. All items of information and the conditions set forth in Section 6 must be accounted for. When multiple

parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt is secured by all of the parcels, the IRS will generally treat all of the parcels as a single property. In such a case, the IRS will generally not consider a ruling request unless (1) each co-owner's percentage interest is the same in all parcels, (2) each co-owner's interest cannot be separated and traded independently, and (3) the parcels are properly viewed a single business unit.

Section 6 of the revenue procedure details 15 conditions for obtaining a favorable ruling, and states that "ordinarily" the IRS will not consider a ruling request unless each one of these 15 conditions is satisfied.

1. TIC Ownership. Each of the co-owners must hold title, either directly or indirectly or through a disregarded entity, as a tenant in common under local law. Title may not be held by an entity recognized under local law (other than a disregarded entity). This title requirement also applies for purposes of electing out of Subchapter K as an "investing partnership." See Reg. Section 1.761-2(a)(2) (investment property must be "owned as co-owners"). So far, so good. Almost all UFI arrangements, by definition, should meet this requirement.

2. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons (as defined in Section 7701(a)(1)). Under Section 7701(a)(1), a person includes an individual, trust, estate, partnership, association, company or corporation. A husband and wife are treated as a single person and all heirs are treated as a single person. This requirement, on its

face, might be circumvented by using an entity to consolidate an unlimited number of cash purchasers as one co-owner. Up to 34 exchangers could then directly own the remaining interests in the property. But for purposes of a ruling request, the IRS may decide to “look through” the entity in determining the number of persons.

3. No Treatment as Entity. The co-ownership may not file a partnership or corporate tax return. It is unclear whether it may do so even for purposes of electing out of Subchapter K but that may be superfluous if the co-ownership is seeking a ruling. The co-ownership may not conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders or members of a business entity, or otherwise hold itself out as a partnership or other business entity. A common bank account is permitted under Section 6.12 but the co-ownership should be careful about how it titles the account. The IRS generally will not issue a ruling if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership. This rules out many situations in which a ruling would be the most useful, including liquidation of a tax partnership and holding property as co-owners before an exchange. Apparently, the IRS does not want the serious problem of attempting to terminate a tax partnership and become a co-ownership to muddy the waters.

4. Limited Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that runs with the land. The agreement may provide that a co-owner must offer the interest for sale to the other owners, the sponsor or the lessee at fair market value before

exercising any right to partition. The agreement may provide voting rights as described in Section 6.05. These are the only two examples given of what may be included in a co-ownership agreement. Presumably, the agreement may contain other provisions that are not in conflict with any of the other conditions of Section 6.

5. Voting. Each co-owner must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases, or the creation or modification of a blanket lien, including the negotiation, renegotiation, extension, or renewal of such agreements or re-leasing of the property (“major actions”). These major actions must be decided by unanimous approval of the co-owners. For all other actions, the co-owners may agree to be bound by the vote of a majority-in-interest. A co-owner who has consented to an action may provide a power of attorney to execute documents for that action but may not give a global power of attorney. The requirement of unanimous approval for major actions may create practical problems and allows a small dissenting owner to block and stalemate the co-ownership. Section 6.10 allows a co-owner to issue an option to purchase his interest (call option). If minority owners dissent, could a co-ownership agreement trigger the call option in the case of deadlock? Would such a provision be consistent with each co-owner retaining the right to approve major actions, or would it make such rights illusory? Compare PLR 8117040 (1/27/81) (no tax partnership where co-owners could approve management decisions by majority vote, but any decision to sell or mortgage the property required approval of 75% of the owners in interest and would be binding on all co-owners); PLR 8048064 (decisions made by co-owners of a majority-in-interest); PLR 8002011 (10/22/79) (co-ownership was tax partnership where co-owners agreed to jointly sell the

property by majority vote, could not transfer their interest to third parties with the prior written consent of all other owners and waived right to partition during term os agreement).

6. Alienation. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's interest in the property without the agreement or approval of any person. Restrictions are not prohibited if they are required by a third-party lender (as provided in Section 6.14) and are consistent with customary commercial lending practices. Further, the other co-owners, the sponsor, or the lessee may have a right of first offer to purchase the interest with respect to any co-owner's exercise of the right to transfer his interest, and a co-owner may agree to offer his interest for sale before exercising any right to partition as provided above. These allowable restrictions may be sufficient to address most concerns over the right to transfer, partition, or encumber a co-owner's interest. If a judgment or other lien attached to a co-owner's interest and the creditor attempted to foreclose on the property, the right of first offer may be triggered with respect to the co-owner's or his creditor's attempt to transfer the interest. Compare PLR 8048064 (grant of right of first refusal to other co-owners and limited waiver of right of partition were allowed); PLR 7832007 (similar to PLR 8048064 and right of first refusal granted to manager if property is sold).

7. Sharing Net Proceeds. If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. This is straightforward and distinguishes a co-ownership from, for example, a limited partnership where the general partner may decide to reinvest the proceeds rather than distribute them to the partners.

8. Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenues and costs in proportion to his undivided interest. The other co-owners, the sponsor and the manager may not advance funds to a co-owner to meet expenses unless the advance is recourse to the co-owner and not for a period exceeding 31 days. See Bergford, supra (manager's advances to co-owners was a form of sharing in losses).

9. Proportionate Sharing of Debts. The co-owners must share in any debt secured by a blanket lien in proportion to their undivided interests. Compare PLR 20019014 (2/10/00) (allowing disproportionate sharing of debt among co-owners in accordance with the terms of their debt-sharing agreement).

10. Options. A co-owner may issue a call option provided that the exercise price reflects the fair market value of the property at the time the option is exercised (without any discount for a fractional interest). A co-owner may not acquire an option to sell the co-owner's interest (put option) to the sponsor, the lessee, another co-owner, the lender, or any person related to them. The rationale behind the prohibition of put options is not entirely clear since such an option enhances the free alienability of the interest, a distinguishing feature of TIC ownership. The IRS may have been concerned that put options make the interests akin to marketable securities.

11. No Business Activities. The co-owner's activities must be limited to those

customarily performed in connection with the maintenance and repair of rental real property (customary activities) as described in Rev. Rul. 75-374, supra. Activities will be treated as customary activities if they would not prevent an amount received by a tax-exempt organization from qualifying as rent under Section 512 (b)(3)(A) and the regulations thereunder. All activities of the co-owners, their agents and any persons related to the co-owners are taken into account, whether or not the activities are performed in their capacities as co-owners (e.g., all activities of a sponsor or lessee are taken into account if the sponsor or lessee is a co-owner). However, activities of a co-owner or related person are not taken into account if the co-owner owns an interest in the property for less than 6 months.

The rents that are excluded from unrelated business income under Section 512(b)(3)(A) and Reg. Section 1.512(b)-1(c) are all rents from real property and all rents from personal property leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease. Rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased. However, such rent is not excluded if either (a) more than 50 percent of the total rents are attributable to personal property, or (b) the determination of the amount of such rents depends in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentages of the gross receipts or sales. The rules contained in paragraph (b)(3) and (6) (other than paragraph (b)(6)(ii)) of Reg. Section 1.856.4 apply for this purpose. Under Reg. Section 1.856(b)(6)(i), if real property is leased to a tenant under terms other than solely on

a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received from the prime tenant with respect to such property is disqualified as "rents from real property."

Further, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally rent from real property. See Reg. Section 1.512(b)-1(c)(5).

12. Management and Brokerage Accounts. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually. The manager may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner),

but may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the property. The manager may negotiate modifications of the terms of any lease or any indebtedness encumbering the property, subject to the unanimous approval of the co-owners as provided in Section 6.05. The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

13. Leasing Agreements. All leasing arrangements must be bona fide for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). The rules for REITs under Section 856(d)(2)(A) and the regulations thereunder apply for this purpose. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the property, cash flow,

increases in equity, or similar arrangements.

14. Loan Agreements. The lender with respect to any debt that encumbers the property or that is incurred to acquire an undivided interest in the property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property. A related person is defined by reference to Sections 267(b) and 707(b)(1) as if the co-ownership were a partnership and each co-owner was a partner.

15. Payments to Sponsor. The amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property

Allowable Services. Rev. Rul. 75-374, 1975-2 C.B. 261, limits the type of services that give rise to an active business and partnership status. Under this ruling, co-owners or their agent may provide "customary tenant services" in connection with the maintenance and repair of an apartment building, such as heat, air conditioning, hot and cold water, normal repairs, trash removal, unattended parking, and common area cleaning and maintenance. The ruling states that furnishing such customary services will not create an active business and render a co-ownership a partnership. Similarly, co-owners or their agent may collect rent and other payments from tenants, and pay taxes, insurance and normal operating expenses without creating a partnership.

See also PLR 200019014 (2/10/00) (corporate general partner of six partnerships that will own apartment complexes as tenants in common will manager the apartment complexes but furnish only customary services to tenants). In PLR 200019014, the IRS ruled that a new partnership will not be formed as a result of the six partnerships owning the apartment complexes as tenants in common, and that the exchange of mobile home parks for TIC interests in the apartment complexes qualified under Section 1031.

However, Rev. Rul. 75-374 states that furnishing additional services, such as attendant parking, other utilities for a separate charge, restaurants, cabanas, recreational facilities, maid service and similar hotel-like services imply the active conduct of a business. In Rev. Rul. 75-374, an unrelated company provided additional services for which tenants paid a separate charge to the company. The company determined the time and manner of performing these services, paid the expenses, and kept all of the income from these services. None of the profits arising from additional services were divided between the co-owners. The ruling holds that the separate provision of additional services did not taint the co-ownership and create a partnership because the company alone furnished the services and kept the profits therefrom.

In a number of private letter rulings, the Service has followed Rev. Rul. 75-374 in respecting co-ownership arrangements that limit themselves to customary tenant services. See, e.g., PLRs 20019014, 8330093, 8048064, 8117040, 7832007, and 7826012. Co-owners may maintain rental property, including apartment and office buildings, out of a tax partnership by following the arrangements described in the above rulings. Co-owners or their agents must not

furnish additional services to tenants or other persons. If additional services are to be furnished, they must be provided by an unrelated and independent operator who will be responsible for the services, pay the expenses and keep the income.

In most small rental properties, such additional services are usually not provided. Thus, co-ownership of such properties may not be reclassified as a tax partnership as long as Rev. Rul. 75-374 applies. However, Rev. Rul. 75-374 has limited facts. All management of the property was conducted by an unrelated company. Further, other facts may have caused the IRS to rule differently and find a tax partnership. It is unclear whether the result in Rev. Rul. 75-374 would be the same if the co-ownership pooled income and expenses in a common bank account, had a co-ownership agreement, had a common trade name, inadvertently filed a partnership return one year, or was a continuation of a prior enterprise operated as a corporation or state law partnership. See, e.g., TAM 199907029 (9/30/98) (tax partnership existed based on long-standing partnership agreement, partnership bank account and filing of partnership returns, despite holding title as tenants in common and providing only customary services to tenants of an apartment building); PLR 8413003 (11/30/83) (pooling of rents for benefit of homeowner's association created tax partnership); PLR 8002111 (co-ownership was tax partnership following liquidation of personal holding company due to agreement to jointly sell property and restrictions of the transfer of co-ownership interests).

**Additional Services.** The line separating customary and additional services to tenants is not clear. The provision of gas, electricity and unspecified other utilities for a separate charge

was listed as an “additional service” in Rev. Rul. 75-374. Presumably, the problem may be avoided by having separate meters with tenants paying such utilities, or by including a standard utility charge in the basic rent and making adjustments thereto. However, utilities such as gas and electricity are usually and customarily provided by a lessor of an apartment building, and separate charges or reimbursements for such utilities, without other “additional services,” should not render a co-ownership a partnership. On the other end of the spectrum, it is clear that services furnished in connection with a hotel or resort are additional services that create an active business. See, e.g., Reg. Sections 1.512(b)-1(c)(5) and 1.1402(a)-1(c)(1)(iii); Rev. Rul. 57-108, 1957-1, C.B. 273 (maid service, instruction in swimming, boating and fishing, delivering messages and mail, etc.) Additional services may also include laundry facilities, vending machines, special security, recreational facilities and similar services that are furnished primarily for the convenience and comfort of tenants. In other words, such services are unlikely to be “customary” services relating to the maintenance and repair of the property. See, e.g., G.C.M. 36251 (recreational facilities may be an additional service depending on facts); PLR 8117040 (laundry facilities “may constitute additional service”).

The factors used to distinguish between customary and additional services include: (1) whether the service is furnished primarily for the personal convenience and comfort of tenants and their guests (additional service); (2) whether the service is usually and customarily rendered by a lessor of property (customary service); (3) whether the service relates to the maintenance and repair of the property (customary service); (4) whether a service or a facility is an integral part of the property (customary service); (5) whether the activity itself constitutes a trade of

business under other Code provisions (additional service); (6) whether the service or facility requires significant time, effort, personnel or capital (additional services); and (7) whether a separate charge is imposed or a profit is earned (additional service). If co-owners are in doubt about whether a service is customary or additional and they desire to avoid partnership status, such services either should not be provided to tenants or should be contracted out to an independent firm. If additional services are contracted out, the co-owners may be able to receive payments from the operator for the privilege of conducting business on the property that are based on the operator's profits. See PLR 8117040 (co-owners received a percentage of gross receipts from the operator of laundry facilities that were installed and maintained by the operator).

**Improvements.** Capital improvements made to a property, beyond deductible maintenance and repair expenses, may imply the active conduct of a business, depending on the nature, extent and purpose of the improvements. Under the rules above, such improvements may constitute an additional service to tenants or other persons that is not customarily performed by a lessor. In the case of new rental units, the construction itself may involve active conduct of a business. However, at least one case holds that improvements made merely to make a property more productive should not render a co-ownership a partnership for tax purposes. See Estate of Appleby, 14 B.T.A. 18 (1940), aff'd 123 F.2d 700 (2d Cir. 1941). In Estate of Appleby, a building on land was demolished to construct a garage at a cost of over \$143,000 (1917 dollars). The garage was constructed to pay taxes and produce income at the suggestion of two auto dealers who became the first tenants, and was later improved with an inside mezzanine floor at a

cost of over \$8,000 (1925 dollars). The court stated that the co-owners did not “operate” the garage and “were merely the owners of the property, which was improved and rented primarily to defray the taxes.”

**Uncertain Case Law.** A plethora of cases have addressed the question of whether a partnership exists in connection with jointly-owned real estate. The cases differ somewhat on the level of business activity necessary to create a tax partnership. The deciding factor in most of these cases is whether the parties intended to create a partnership, as evidenced by their agreement, actions, use of a common name, holding of title, partnership bank accounts, filing of partnership tax returns, level of business activity, manner of operation, pooling of income and expenses, degree of individual or joint control, and continuation of a business enterprise in another form. The courts find that if a co-ownership has operated like a partnership, it is a partnership. In these cases, the fact that title to property was taken as tenants in common is not determinative and “may be considered neutral evidence.” McManus v. Commissioner, 583 F.d 443, 447 (9<sup>th</sup> Cir. 1978).

Further, the filing of Forms 1065, and the reporting of a partner’s distributive share on his own tax return, may conclusively establish partnership status against claims by a co-owner to the contrary. See McManus, supra at 447 (“A taxpayer is estopped from later denying the [partner] status he claimed on his tax returns”); PLR 8916034 (filing a partnership tax return and opening a partnership bank account evidenced an intent by co-owners to form a partnership, despite no significant services to tenants and prior co-ownership status). However, earlier cases have held

that filing a partnership return is not determinative of partnership status. Needless to say, co-ownerships desiring to avoid partnership status should not file Form 1065, unless they are required to do so in order to make an election out of Subchapter K. See Madison Gas and Electric Company v. Commissioner, 72 T.C. 521, 558, aff'd 633 F.2d 512 (7<sup>th</sup> Cir. 1980) (the filing of a partnership return and election-out under Section 761(a) are not “admissions” of partnership status).

With the significant exception of Rev. Rul. 75-374 and some private letter rulings that followed it, the trend of the cases and rulings is to find a tax partnership in co-ownership cases upon a showing of minimal business activity and joint conduct. See, e.g., Cusick v. Commissioner, T.C.M. 1998-286; Estate of Aaron Levine v. Commissioner, 72 T.C. 780 (1979). See also Baker v. Commissioner, T.C. Memo 1997-442; Winkler v. Commissioner, T.C. Memo 1997-4; Marinos v. Commissioner, T.C. Memo 1989-492; Bergford, *supra*. Compare Gabriel v. Commissioner, T.C. Memo 1993-524; Lattin v. Commissioner, T.C. Memo 1995-233; Clifton v. Commissioner, T.C. Memo 1995-528.

The recent case of Cusick is a case of “man bites dog.” The IRS argued that the rental property was owned by co-owners, while the taxpayer claimed to be a partners in a tax partnership in order to deduct expenses that had accrued and were unpaid or paid by others. The court held that despite the lack of any formalities evidencing a partnership, the co-owners met the definition of a tax partnership because they were engaged in a business activity and shared profits and losses. At different times, each co-owner in Cusick managed a commercial property where office space was rented to a variety of month-to-month tenants. The management of the property

“was difficult and required a significant amount of time.” The co-owners “not only maintained books and records and collected rent, but also performed maintenance tasks such as fixing backed-up toilets and assisting tenants who were locked out of their offices.” The court held that the “degree of business activity” exhibited by the co-owners in conducting their rental real estate activities caused the relationship to be characterized as a tax partnership.

Cases that have upheld co-ownership arrangements are older cases or usually involve property inherited by family members (persons who had co-ownership “thrust upon them”). Moreover, the courts have literally applied a very broad statute, and found co-owners to be partners if they or their agents carry on the requisite “degree of business activities,” regardless of whether or not they intended to form a partnership or share in a joint cash profit. In Madison Gas and Electric Company, *supra*, 633 F.2d at 514-15, the court stated: “At bottom MGE’s position is that it is not sound policy to treat the [co-ownership] entity here as a partnership. But we are not free to rewrite th tax laws, whatever the merits of MGE’s position.”

As one commentator stated in 1961, “a twilight zone separates co-ownership of property from joint ventures or partnerships. The boundaries in this area were reasonably well-established prior to the 1954 Code, but the provisions of the Section 761(a) election seem to have moved the partnership line well over into the area that was previously mere co-ownership.” Cruikshank, “Are Co-owners Partners? Code Raises Doubts; Electing Exclusion Urged,” 15 Journal of Taxation 166 (September 1961). See also Note, “The Fine Line Between Partnership and Co-ownership.” Utah Law Review 495 (Summer 1975). Given the enactment of Section

1031(a)(2)(D), the issue of tax status as a co-ownership or a partnership has been revitalized, and the stakes of the outcome have been raised. In the absence of a ruling under Rev. Proc. 2002-22 or a valid Section 761(a) election, nonrecognition treatment under Section 1031 will depend on uncertain case law determining whether or not a co-ownership is a partnership for tax purposes. The burden of proof will be on co-owners of rental real estate to prove that they are not partners. See Rothenberg v. Commissioner, 48 T.C. 369 (1967).

The inadvertent creation of a tax partnership by a co-ownership remains one huge trap for the unwary under Section 1031, and the Service is well aware of it. See, e.g., TAM 199907029 (9/30/98) (co-ownership was tax partnership and had to exchange as a partnership); FSA 199951004 (9/3/99) (substance of transaction was exchange of partnership interest); PLR 9818003 (12/24/97) (replacement properties conveyed directly to partners in liquidation of their interests disqualified partnership's exchange); PLR 9741017 (7/10/97) (exchange of interests in rental properties did not qualify under Section 1031 because the interests were deemed to be interests in a tax partnership); PLR 9645005 (7/32/96) (partner cannot individually defer gain on property distributed one day before closing of condemnation sale; replacement property had to be purchased by joint venture under Section 1033). Compare PLR 9022037 (3/5/90) (partnership conveyed property to partners as tenants in common, 18 days later partners sold property under threat of condemnation, and partners individually were eligible to purchase replacement property under Section 1033 since they were tenants in common at the time of the sale). See generally, Phillips & Rocca, "Exchanges By 'Partners' under Section 1031" (5th Annual NRDC Conference) (May 4, 1992).

**Conclusion.** Most of the conditions set forth in Section 6 of the revenue procedure are not surprising and are consistent with prior authorities addressing the co-ownership/partnership issue. See Appendix A. Sponsored UFI arrangements that are “vanilla programs” should be able to meet these conditions. For example, if the co-owners enter into a net lease of their property to a third party lessee, who in turn re-leases the property to tenants, the UFI arrangement should satisfy the conditions for a ruling provided that (1) the number of co-owners does not exceed 35 persons; (2) the lessee is not the taxpayer’s agent, a co-owner or a person related to a co-owner (so that the activities of the lessee are not attributed to the co-owners); (3) the lease meets the requirements of Section 6 and there is no sharing of profits and losses or other “shared economic interest” between the co-owners and the lessee; and (4) a sponsor’s compensation does not exceed fair market value or depend, in whole or in part, on the income or profits of any person in the property. In these arrangements, the co-owners may not even enter into any type of co-ownership or management agreement involving the property, although limited agreements are allowed under the revenue procedure. Instead, the rights of the co-owners concerning the property are set forth in the lease with the lessee. These arrangements are the most likely to qualify as “RETICs” (or ruling-eligible tenancy-in-common interests).

These arrangements may be contrasted with situations in which the co-owners enter into both a co-ownership agreement and hire a manager to actively manage the property on their behalf. Even if the property generates only rental income, there is a significant risk that such an arrangement would be treated as a tax partnership depending on the activities of the manager (which will be attributed to the co-owners) and whether any additional services are provided to

tenants. Similarly, many sponsored UFI arrangements that provide for enhanced returns to sponsors, including any type of cash flow or equity participation, will not be eligible to obtain a ruling under Section 6.15 of the revenue procedure.

Rev. Proc. 2002-22 also has implications for traditional co-ownerships that do not involve any sponsors. Traditional co-ownerships of rental real property may also request rulings under the revenue procedure. The requests would simply state that there are no promotional documents and there is no sponsor. Even if traditional co-ownerships see little benefit and desire to avoid the expense of a ruling request, they can use the conditions set forth in Section 6 (most of which are consistent with prior authorities) to avoid reclassification as a partnership. While these conditions “are not intended to be substantive rules and are not to be used for audit purposes,” an arrangement that satisfies these conditions (and thus is “ruling eligible”) is very unlikely to be recharacterized by the IRS as a tax partnership. At least in this respect, the conditions in the revenue procedure are like having a pink elephant in the room that everyone sees but is told to ignore.

### **QIs, EATs and Agency**

This section discusses QIs, EATs and agents. When can one be another under the exchange regulations and Rev. Proc. 2000-37? When is a QI or an EAT considered an “agent” under case law or state law? What do these terms mean?

A QI is a person who (A) is not the taxpayer or a disqualified person (as defined in Reg. Section 1.1031(k)-1(k)) and (B) enters into a written agreement with the taxpayer (the “exchange

agreement”) and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. Reg. Section 1.1031(k)-1(g)(4)(iii). The exchange regulations provide a safe harbor for simultaneous and deferred exchanges facilitated by a QI, pursuant to which a QI is “not considered” the agent of the taxpayer for purposes of Section 1031. Reg. Sections 1.1031(b)-2 and 1.1031(k)-1(g)(4).

The regulations allow a QI to enter into agreements for the acquisition and transfer of property “either on its own behalf or as the agent of any party to the transaction,” presumably including the taxpayer. Reg. Section 1.1031(k)-1(g)(4)(iv). QI may be an agent of the taxpayer under state law (and perhaps for other federal income tax purposes) and still be within the QI safe harbor. See also Reg. Section 1.1031(k)-1(g)(4)(vi) (ignoring rights under state law to terminate or dismiss a QI, including state agency law). If all of the other requirements of Section 1031 and the regulations are met, the IRS will not challenge an exchange with a QI even if the QI is in fact the taxpayer’s agent. The exchange will qualify under Section 1031, assuming that the QI safe harbor is valid in permitting an exchange with the taxpayer’s agent.

An EAT is a person who (A) is not the taxpayer or a disqualified person and is subject to federal income tax (or if it is a pass-through entity,) more than 90% of its interests or stock are owned by partners or shareholders who are subject to federal income tax); and (B) holds qualified indicia of ownership of property, such as legal title, from the date of its acquisition until the property is transferred to the taxpayer as replacement property or to a person who is not the

taxpayer or a disqualified person as relinquished property. Section 4.02(1) of Rev. Proc. 2000-37, 2000 I.R.B. 308. An EAT must satisfy additional requirements under Section 4.02 for the arrangement with the taxpayer to be a qualified exchange accommodation arrangement (QEAA), including entering into a written agreement (a qualified exchange accommodation or QEA agreement) with the taxpayer no later than five business days after the transfer of property to the EAT. The QEA agreement must specify that (i) the EAT is holding the property for the benefit of the taxpayer to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37; (ii) the EAT and the taxpayer will report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37; (iii) the EAT will be treated as the beneficial owner of the property for all federal income tax purposes; and (iv) both parties will report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the QEA agreement.

Rev. Proc. 2000-37 provides an administrative safe harbor for reverse exchanges that are completed within 180 days after an EAT acquires property as part of a QEAA. The EAT may acquire and transfer (i) the replacement property in a future exchange under the “exchange last” method or (ii) the relinquished property in a current exchange under the “exchange first” method. Services for the taxpayer in connection with a person’s role as an EAT in a QEAA are not taken into account in determining whether that person or a related person is a “disqualified person” under Reg. Section 1.1031(k)-1(k). Section 3.03 of Rev. Proc. 2000-37. Thus, a person may act as an EAT and not be disqualified from serving as a QI. Further, an EAT that satisfies the requirement of the QI safe harbor may serve as the QI in a simultaneous or deferred exchange

without the property failing to be treated as being held in a QEAA. Section 4.03(1) of Rev. Proc. 2000-37. Rev. Proc. 2000-37 does not expressly state whether or not an EAT in a QEAA may be the taxpayer's agent.

An agent acts on behalf of a principal with actual or apparent authority, so that the acts of the agent are considered the acts of the principal. It is meaningless (at least for tax purposes) for a principal to exchange property with his agent because he would be exchanging property with himself (i.e., not exchanging at all). In Commissioner v. Bollinger, 485 U.S. 340 (1988), the Supreme Court (in an unanimous opinion) stated that "it is uncontested that the law attributes tax consequences of property held by a genuine agent to the principal." Thus, if an exchange accommodator sold property, purchased property or held title to property as the taxpayer's agent, the taxpayer would be deemed to sell, purchase or hold title to the property, and not exchange property with the accommodator.

A person who merely satisfies the definition of a QI or an EAT, without more, is not necessarily the taxpayer's agent. The courts have consistently held that the fact that an accommodator is used to facilitate a like-kind exchange does not mean that the accommodator is the taxpayer's agent. See Biggs v. Commissioner, 632 F.2d 1171 (5<sup>th</sup> Cir. 1980), aff'g 69 T.C. 905 (1978) (corporation owned by taxpayer's attorney and used to acquire replacement property to facilitate exchange was not taxpayer's agent); J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq. 1963-2 C.B. 4 (realty company was not taxpayer's agent even though it held sales proceeds in an account "under the name of Realty, Escrow Agent for Baird" and the taxpayer had to approve all construction and related invoices); Barker v. Commissioner, 74 T.C.

555 (1980) (a party can acquire transitory ownership of exchange property solely for purposes of effecting the exchange); Fredericks v. Commissioner, T.C. Memo 1994-27 (related construction company was not taxpayer's agent but simply acquired replacement property and constructed improvements to facilitate the taxpayer's like-kind exchange); Rutland v. Commissioner, T.C. Memo 1977-8 ( bank owned and controlled by the taxpayer acted in a fiduciary capacity to buyer and was not taxpayer's agent); Coupe v. Commissioner, 52 T.C. 394 (1969), acq. in result only, 1970-1 C.B. xv (taxpayer's attorney acted as de facto agent of buyer, not taxpayer); Mercantile Trust Company v. Commissioner, 32 B.T.A. 82 (1985) (title company acted as fourth-party intermediary to facilitate exchange and was not taxpayer's agent). See also PLR 200111025 (3/16/01) (applying the Supreme Court's agency analysis to determine whether an EAT is the taxpayer's agent in a non-safe-harbor reverse exchange).

Despite the impressive line of cases finding that an exchange facilitator is not the taxpayer's agent, some taxpayers have gone too far. Their exercise of control over a facilitator or account holder evidenced actual or constructive receipt of the exchange funds. See Florida Industries Investment Corp. v. Commissioner, T.C. Memo 1999-346, aff'd 87 AFTR2d Par. 2001-749 (11<sup>th</sup> Cir. 2001) (taxpayer's attorney who purportedly acted as buyer's trustee under escrow agreement merely "complied with the wishes of Mr. Canty [the taxpayer's owner], regardless whether those actions violated" the agreement, showing the taxpayer's control over the escrowed sales proceeds from the start of the transaction); Dobrich v. Commissioner, 188 F.3d 512 (9<sup>th</sup> Cir. 1999) (unpublished opinion), aff'g T.C. Memo 1997-477 (control over intermediary was evidenced by intermediary's assistance in preparing backdated documents, resulting in

constructive receipt of exchange funds and failure to qualify for installment sale treatment); Greene v. Commissioner, T.C. Memo 1991-403 (account holder was taxpayer's employee, disbursed funds on taxpayer's demand and was treated as taxpayer's agent); Ng v. Commissioner, T.C. Memo 1997-248 (seller of replacement property, the taxpayer's wholly owned corporation, was taxpayer's agent).

With these terms and legal background in mind, we examine recent developments affecting QIs and EATs. We also look at the related issue of agency. Under Rev. Proc. 2000-37, it appears that a QI can be an EAT and an EAT can be a QI, as long as that person qualifies and acts within each respective safe harbor. But can a QI or EAT expressly act as the taxpayer's agent? If so, to what extent can a QI or EAT be the taxpayer's agent? What are the advantages and disadvantages of a QI or EAT acting as the taxpayer's agent?

**Final Regs. on Banks and Bank Affiliates.** We discussed in last year's program a proposed regulation to allow more banks to serve as QIs. Reg. 107175-00 (1/17/01). As a result of recent changes in law and policy, many banks have become members of controlled groups that include investment banking and brokerage firms. Final regulations were recently issued, expanding the exception to the term "disqualified persons" for bank affiliates as well as for banks (as provided in the proposed regulations). See T.D. 8982 (2/1/02). The regulation applies to transfers of property made after January 16, 2001. If another member of the same controlled group provides investment banking or brokerage services to the taxpayer within the 2-year period before the exchange, those services will not make a bank or bank affiliate a "disqualified person"

under Reg. Section 1.1031(k)-1(k). A “bank affiliate” is defined as a corporation whose principal activity is rendering services to facilitate Section 1031 exchanges and all of whose stock is owned by either a bank or a bank holding company. Reg. Section 1.1031(k)-1(k)(4)(ii).

Some comments to the proposed regulations suggested that an exception for the banking industry would erode the integrity and purpose of the disqualified person concept. But these comments were rejected. The Preamble to the regulations notes that banks and their affiliates are closely regulated institutions that have historically acted as neutral and independent holders of funds. Treasury and the IRS continue to believe that recent changes to federal banking laws are unlikely to impinge on this role to any significant degree. Thus, the amendment to the regulations allows banks and their affiliates to continue their traditional practices of providing qualified escrow, qualified trust and qualified intermediary services. Banks and affiliates can do so without violating the disqualified person rules simply because they are members of a controlled group that includes investment banks and brokerage firms that provided such services to the taxpayer within the two-year period before the exchange.

By its terms, this exception only applies to the investment banking and brokerage services provided by another member of the controlled group during the 2-year period. Such services are disregarded for purposes of applying the related party test to the bank or bank affiliate under Reg. Section 1.1031(k)-1(k)(4)(i). The exception does not apply if the bank or bank affiliate that serves as the QI itself performed investment banking or brokerage services in the 2-year period under Reg. Section 1.1031(k)-1(k)(2). Thus, if any investment banking or brokerage services

were provided to the taxpayer in the 2-year period, it will be necessary to know precisely what firm or firms “provided” or “performed” the services. What if the bank or bank affiliate that serves as QI recommends or facilitates such services?

One commentator suggested that the final regulations include the exception from the disqualified person rule set forth in Section 3.03 of Rev. Proc. 2000-37. Section 3.03 provides that services in connection with a person’s role as an EAT in QEAA are not taken into account in determining whether that person or a related person is a disqualified person. The Preamble states that “Treasury and the IRS do not believe that this rule needs to be restated in these regulations.” (Emphasis added.) Therefore, the final regulations did not include this exception.

If services are performed as an EAT, either by a person that later serves as a QI or a related person (applying the 10% test of Reg. Section 1.1031(k)-1(k)(4)(i)), taxpayers may still rely on Section 3.03 of Rev. Proc. 2000-37 so that the QI is not considered a disqualified person. Similarly, the EAT itself may serve as a QI and the property will still be considered to be held as part of a QEAA, provided that all of the other requirements for QEAA are met. Section 4.03(1) of Rev. Proc. 2000-37. Treasury and the IRS declined to include the exception for services as an EAT in the final regulations, believing that “this rule does not need to be restated” there. But clarification of these rules would have been helpful. For example, are services performed by an EAT in a non-safe-harbor reverse exchange also disregarded in determining whether that person or a related person is a disqualified person? Even if Section 3.03 did not apply to such services, the EAT’s services may also be disregarded as services performed in connection with an

exchange intended to qualify under Section 1031. See Reg. Section 1.1031(k)-1(k)(2)(i).

**PLR 200148042: EAT As Agent.** In PLR 200148042, the IRS ruled that the inclusion of an express agency statement, making the EAT an agent of the customer for all purposes except federal income tax purposes, will not adversely affect a QEA agreement under Rev. Proc. 2000-37. Thus, according to this ruling, an EAT can be the express agent of an exchange customer for all purposes except federal income tax purposes and still be within the safe harbor provided by the revenue procedure. But if the parties stray one step outside of the safe harbor, an express agency statement is likely to be fatal to the exchange. See discussion of agency above and Appendix B.

Logically, the EAT cannot simply be the agent of the customer for all purposes. The EAT cannot be the agent of the customer for federal income tax purposes because of the provisions of Section 4.02(3) of the revenue procedure. Section 4.02(3) provides that a QEA agreement must specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes. Further, both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement. If the EAT were also the agent of the customer for federal income tax purposes, the provisions of Section 4.02(3) could not be satisfied because the customer as principal, and not the EAT as agent, would be treated as the beneficial owner of the property. Accordingly, the express agency statement in the ruling is limited and had to be limited so that the EAT acts as an agent of the customer for all purposes except federal income tax purposes.

**What are the advantages and disadvantages of such an agency relationship?** An

express agency statement may help the parties avoid additional transfer tax. Transfer tax may be avoided on the transfer of replacement property by the EAT to the customer using the “exchange last” method or on the transfer of the relinquished property by the customer to the EAT using the “exchange first” method. For state and local purposes, the transfer of title would be from agent to principal or principal to agent with no change in beneficial ownership. Such transfers of title should be exempt from transfer tax in most state and local jurisdictions.

In addition, an EAT acting as agent would be entitled to all of the immunities and protections of an agent under state and local law, including indemnification by the principal, provided that the EAT acts within its authority. A principal would be protected from actions by the agent outside of the agent’s actual or ostensible authority. An agent may also be accountable as a fiduciary to the principal under state and local law. The principal would be regarded as the beneficial owner of the property if the EAT died (assuming the EAT was an individual), dissolved or became bankrupt. Accounting, financing and regulatory treatment of the transaction may also be simplified if the EAT is merely the agent of the customer for all purposes except for federal income tax purposes.

The main disadvantages to an agency relationship include the potential legal risks to the principal of being bound by the acts of his agent. The principal may incur liabilities to third parties due to the acts or omissions of his agent that the principal would not otherwise incur in the absence of an agency relationship. Further, the exchange may be subject to income tax under

state law. States are not bound by the administrative safe harbor provided in Rev. Proc. 2000-37 for federal income tax purposes. In general, the tax consequences of property held by an agent are attributed to the principal so that the principal is treated as the beneficial owner of the property. As noted above, an exchange involving such an agent would be meaningless. The principal would be treated under state law as “exchanging” for replacement property that he already owns through his agent under the “exchange last” method (i.e., not exchanging for anything), or as selling relinquishing property through his agent under the “exchange first” method (i.e., making a taxable sale).

Perhaps this result could be mitigated if the express agency statement is modified to provide that the EAT is acting solely as the agent of the customer for all purposes except federal and state income tax purposes. But that modification may work only in a state that already adopted Rev. Proc. 2000-37 or otherwise follows its principles for state income tax purposes. Without having adopted the revenue procedure, state income tax authorities are likely to question (as anyone with common sense would) how someone can be an agent for all purposes “except federal and state income tax purposes”? Outside of Rev. Proc. 2000-37, this statement may not make any sense.

Of course, the other big tax disadvantage is that the exchange presumably will not qualify under Section 1031 if the parties go one inch outside of the safe harbor. This could occur if any of the requirements for a QEAA are not met (e.g., the EAT is a disqualified person, the parties do not report transaction in a manner consistent with the QEA agreement, or the transaction is not

completed within 180 days after the EAT acquires title). Further, the exchange would not qualify under Section 1031 if the safe harbor is otherwise inapplicable (e.g., a court finds it invalid to the extent that it allows for an exchange between a principal and his agent).

Outside of the safe harbor, the IRS may challenge the qualification of the property as “replacement property” or “relinquished property” and the treatment of the EAT as the beneficial owner of the property “without regard to the provisions of this revenue procedure.” Section 3.04 of Rev. Proc. 2000-37. The proper treatment of the transactions would be determined under general tax principles. One may argue that the express agency statement in the PLR is not necessarily fatal outside of the safe harbor. The statement disavows, after all, any agency for federal income tax purposes, at least showing an intent for the EAT to be treated as the beneficial owner for all federal income tax purposes, including Section 1031. But it is unclear what, if anything, such a statement means outside of the safe harbor. The limitation of the agency “for federal income tax purposes” is likely to be ignored. In any event, an express agency statement dramatically reduces the taxpayer’s chances of having a good exchange outside of the safe harbor.

Rev. Proc. 2000-37 does not itself say that an EAT may be an agent of the taxpayer for any purpose, let alone for all purposes except for federal income tax purposes. Rev. Proc. 2000-37 says that an EAT may not be the taxpayer or a disqualified person. Disqualified persons under Reg. Section 1.1031(k)-1(k)(2) include agents of the taxpayer at the time of the transaction and persons who acted as the taxpayer’s employee, attorney, accountant, investment banker or

broker, or real estate agent or broker within the 2-year period before the transfer of the first relinquished property. However, in determining whether a person is the taxpayer's agent, the following services are ignored: (i) services for the taxpayer with respect to exchanges intended to qualify under Section 1031; and (ii) routine financial, title insurance, escrow, or trust services for the taxpayer by a financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company. Accordingly, an EAT would not be a "disqualified person" if it acted as the taxpayer's agent and its only services for the taxpayer (at that time or during the 2-year period) were services that are disregarded (including services with respect to exchanges of property intended to qualify under Section 1031). Rev. Proc. 2000-37 also provides rules that coordinate EATs and QIs. Section 3.03 ignores services performed by an EAT in a QEAA in determining whether that person or a related person is a disqualified person. Section 4.03(1) allows an EAT to serve as a QI in a simultaneous or deferred exchange. If a QI may act as an agent of the taxpayer in entering into agreements under Reg. Section 1.1031(k)-1(g)(4)(iv), an EAT that served as a QI could presumably do so as well.

Notwithstanding the above, Rev. Proc. 2000-37 also requires that a QEA agreement specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes. As noted above, if EAT acts as the agent of the taxpayer for all purposes (including federal income tax purposes), the taxpayer as the principal would be treated as the beneficial owner of the property for federal income tax purposes. That would be inconsistent with the required terms of a QEA agreement. Thus, while Rev. Proc. 2000-37 does not specifically address whether an EAT may be the taxpayer's agent for other purposes, it logically

rules out the EAT being the taxpayer's agent for federal income tax purposes.

In PLR 200148042, the express agency statement provided that “[LLC] is acting solely as [Customer's] agent for all purposes, except for federal income tax purposes.” The IRS stated: “It is believed that in many jurisdictions, this express agency statement (for non federal income tax purposes) will help avoid additional transfer tax when, for example, LLC transfers legal title to [replacement] property to its exchange customers.” Additional transfer tax may also be avoided under the “exchange first” method when the customer transfers legal title to the relinquished property to the EAT. Avoiding duplicative transfer tax was the sole reason given for inclusion of the agency statement in the QEA agreement, but the parties may also have legal, accounting, regulatory, financing and other reasons for creating an agency relationship.

In the ruling, the EAT was a corporation affiliated with a QI and acted as an EAT indirectly through its ownership of an LLC (a wholly-owned, single-member, disregarded entity). The EAT could have transferred ownership of its interest in the LLC to its customer in an attempt to avoid additional transfer tax. See PLR 200118023 (1/31/01). But that would mean that the EAT would need to form a new LLC for each exchange customer and incur additional organization, tax and accounting costs. Further, depending on the state and local jurisdiction, a transfer of majority ownership in a partnership or LLC could trigger transfer tax, even though there is no conveyance of legal title. In any event, the EAT in the ruling chose to use an agency statement in its QEA agreement rather than simply transfer the ownership interest in the LLC.

The IRS stated that if the parties use most or all of the side agreements or arrangements permitted under Section 4.03 of Rev. Proc. 2000-37 (e.g., guarantees, indemnities, loans, leases, management agreements, put and call agreements, adjustments for variations in values), the EAT “will likely be considered an agent of the customer under state law.” The IRS cited Section 2.05 of Rev. Proc. 2000-37 for this proposition and no other authority. But Section 2.05 merely discusses the use of parking transactions to facilitate reverse like-kind exchanges and states that “taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.” Section 2.05 says nothing about the accommodation party being the taxpayer’s agent in a “parking” transaction. It also does not address the effect of using any of the side or arrangements permitted under Section 4.03 and whether such use would create an agency relationship.

The statement in the ruling that the EAT will likely be the taxpayer’s agent under state law if the side agreements are used is not supported by any authority or analysis. But it signals the IRS’s likely position if side agreements are used and the reverse exchange falls outside of the safe harbor. See TAM 200039005 (5/31/00, but not released until after Rev. Proc. 2000-37) (EAT was the taxpayer’s agent where there was no written exchange or lease agreement and taxpayer (i) supplied all funds for purchase, (ii) was personally liable on mortgage, and (iii) had exclusive use of parked property); DeCleene v. Commissioner, 115 T.C. No. 34 (2000) (buyer-accommodator had no benefits and burdens of ownership and taxpayer continued to be beneficial owner of replacement property). Compare PLR 200111025 (12/18/00) (EAT in a non-safe-

harbor reverse exchange was not the taxpayer's agent although side agreements were used). TAM 200130001 (discussed below) suffers from the same defect as PLR 200128042 in merely concluding, without authority or analysis, that a QI in a transaction that does not comply with the safe harbor under the deferred exchange regulations is ipso facto the agent or nominee of the taxpayer. See Appendix B discussing authorities on agency.

Using this very questionable premise (that an EAT is likely to be the taxpayer's agent under state law if side agreements are used), the IRS concludes that an express agency statement may be used based on Section 5.04 of Rev. Proc. 2000-37. Section 5.04 provides that property will still be considered held in a QEAA, even though the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the EAT is different from the treatment required by Section 4.02(3) (i.e., that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes). The ruling also notes that its analysis is consistent with the intent behind the QI safe harbor, "which has many parallels to the rules and requirements of the revenue procedure." In particular, Reg. Section 1.1031(k)-1(g)(4)(iv) provides that rights conferred upon a taxpayer under state law (including state agency law) to terminate or dismiss a QI are disregarded in determining whether the taxpayer has the immediate right or ability to receive or otherwise obtain the benefits of money or other property held by the QI. See also Preamble to T.D. 8346, 1991-1 C.B. 150, 152.

The bottom line is Rev. Proc. 2000-37 is silent on the question of whether an EAT may be the taxpayer's agent for purposes other than federal income tax purposes and still be within its

safe harbor. But Sections 3.03, 4.03(1) and 5.04, of the revenue procedure, together with the analogy to QIs under the deferred exchange regulations, indicate that such an agency relationship should not adversely affect a QEA agreement. The IRS stated: “For Customer to obtain the benefits of the safe harbor rules of the revenue procedure, the transaction need only fit within the confines of the safe harbor rules. Assuming the boundaries of the safe harbor rules are not exceeded, Customer is entitled to enjoy the protection afforded to all compliant taxpayers by these rules, notwithstanding inconsistent treatment or characterization under state or local law.”

But it should be emphasized that this treatment of an EAT that is also an agent only applies to and within the formalistic world created by the safe harbor. Only in that world does it make sense to have an agent for all purposes “except for federal income tax purposes.” The world in which the safe harbor operates is a strange world indeed ----- a world in which Humpty Dumpty is king and words mean no more and no less than what he says they mean.

**TAM 200130001: Accommodator Fails QI Test and Considered Taxpayer’s Agent.**

The facts of this TAM involve a “parking” transaction under the “exchange last” method for reverse exchanges, but the IRS did not analyze this aspect of the transaction. Instead, the IRS focused on the failure to comply with the QI safe harbor in two respects: (i) the failure to give written notice of the assignments to the purchasers before the transfer of each relinquished property as required by Reg. Section 1.1031(k)-1(g)(4)(v); and (2) the failure of the exchange agreements to expressly limit the taxpayer’s rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the QI as required by Reg. Sections 1.1031(k)-

1(g)(4)(ii) and (g)(6). The IRS could have cited other problems with the exchange. But it chose the ruling to make a point about the QI safe harbor: violating its “specific and exact” requirements is perilous and very likely fatal in the IRS’s view.

In the ruling, the QI first acquired and held title to the replacement property using a purchase-money loan from a bank. The QI subsequently transferred an undivided interest in the replacement property to the taxpayer after the sale of the first relinquished property. The remaining undivided interest was transferred after the sale of the other two relinquished properties. The taxpayers mortgaged the two relinquished properties to secure the first undivided interest in the replacement property transferred by the QI to the taxpayers. The taxpayers (husband and wife) transferred the undivided interest to their wholly-owned LLC immediately after receiving it from the QI. The taxpayers leased from the QI the remaining undivided interest on an “absolutely net basis” at a rate approximately equal to the amount payable to the bank on the replacement property loan. The QI assigned all leases and rents to the bank. The proceeds from the sale of the last two relinquished properties were paid to discharge the mortgage debt owed on the replacement property by the taxpayers and the QI, as well as mechanic liens, attorney’s fees and commissions. The QI then transferred the remaining undivided interest in the replacement property to the taxpayers, and the taxpayers thereupon transferred this interest to the LLC.

The IRS did not address any issues arising out of parking the replacement property with the QI. The transaction may have occurred before the effective date of Rev. Proc. 2000-37 on

September 15, 2000. No issues were discussed concerning the undivided interest received by the taxpayer (and whether that interest may have constituted a partnership interest); the mortgaging of the two relinquished properties before the exchange (although this may have not been problematic if the taxpayers did not refinance to take out cash and merely gave additional security to the bank); the use of the sales proceeds to pay down the debt on the undivided interest that the taxpayers already owned; or the taxpayers' immediate transfers of their undivided interests in the replacement property to their wholly-owned LLC. The LLC had two members, the husband and wife, and presumably was not a disregarded entity. This presented a holding issue under Rev. Rul. 75-292, 1975-2 C.B. 333. See also PLR 200131014 (5/2/01).

The taxpayers and the QI managed to do some things right. The taxpayers did enter into written exchange agreement with the QI, and they assigned their interests in each sale agreement to the QI before the transfer of each relinquished property. But the taxpayers could not prove that any written notices of the assignments were given to the purchasers of these properties before the transfers. Further, the exchange agreements provided for an exchange of the relinquished properties for other property "to be determined" (and not otherwise specified in writing), although the replacement property was obviously known by the parties. The exchange agreements also did not contain any provision that expressly limited the taxpayers' rights to receive, pledge, borrow or otherwise obtain the benefits of the sales proceeds before the receipt of the replacement property.

After detailing the relevant provisions of the QI safe harbor, the IRS began its analysis of these requirements as follows: "The safe harbor rules of section 1.1031(k)-1(g) provide

institutionalized mechanisms for preventing actual or constructive receipt by a taxpayer of money or other property in a deferred exchange. The mechanism which Taxpayers attempted to use is the ‘qualified intermediary’ safe harbor set forth and outlined in paragraph (g)(4) of this regulation. However, the rules for application of the qualified intermediary safe harbor to a transaction or series of transactions are specific and exact. If those rules are not followed with precision, the integrity of the transaction as an exchange qualifying for deferral under section 1031 is jeopardized. In the transactions at issue, Taxpayers failed to comply with at least two requirements of the ‘qualified intermediary’ safe harbor.” See also PLR 200027028 (4/10/00) (strictly construing Reg. Section 1.1031(k)-1(g)(6) with respect to the release of exchange funds to the taxpayer); FSA 200048021 (8/29/00) (escrow agreement deemed to violate (g)(6) limitations). Compare PLR 20010922 (11/29/00) (QI strictly complied with written notice requirement and (g)(6) limitations in mass exchange program). All of these rulings were discussed in last year’s NRDC program.

As to the written notice requirement, the IRS noted that in none of the transactions did the QI receive a transfer of title to the relinquished property. Rather, in each instance, the sales contracts were assigned to the QI and the relinquished properties were conveyed directly to the purchasers without mentioning any involvement of the QI. The taxpayers could not prove that written notice of the assignments was ever given to the purchasers. The taxpayers argued that each purchaser had “actual notice” of the assignment and, therefore, they substantially complied with the notice requirement. However, the fact that the settlement statement listed the QI as seller was, according to the IRS, also consistent with the QI acting as the agent or nominee of the

seller. The settlement statement, in and of itself, did not constitute written notice of an assignment of rights to the QI. The taxpayers also submitted after-the-fact letters written by the QI and the purchasers. But these letters did not contain unequivocal statements that the purchasers were timely given written notice of the assignments and were not submitted under penalties of perjury.

Since the taxpayers did not produce sufficient evidence of compliance with the written notice requirement, the IRS concluded that the taxpayer failed to satisfy the requirement. The QI could not be treated as having entered into agreements to sell the relinquished properties under Reg. Section 1.1031(k)-1(g)(4). The taxpayers were treated as if they transferred the property directly to the purchasers for money or other property “with no involvement of a qualified intermediary in that sale except, perhaps, as an agent or nominee.” Absent the involvement of a QI as such, the form of the transaction was deemed to be a separate sale and a separate purchase to which Section 1031 did not apply.

The taxpayers and QI could have easily avoided this problem by giving written notice of the assignments to the purchasers before the transfers of the properties and retaining evidence that such written notice was timely given. For example, the assignment to the QI could have been signed and dated by the purchasers before the transfers. The purchasers could have approved the assignment or simply acknowledged that they received written notice thereof. If the purchasers were unwilling or unable to sign a consent or acknowledgment of the assignment, written notice of the assignment could have been sent by certified mail, personal service, fax transmission or other means where receipt by the purchasers could be confirmed.

Reg. Section 1.1031(k)-1(g)(4)(v) requires that both (i) an assignment of rights of a party

to the agreement is made to the QI and (ii) all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the property. The TAM indicates that taxpayers must strictly and exactly comply with this requirement, and they will bear the burden of proving that they did so. In the haste to close transactions, this requirement should not be overlooked, treated cavalierly, or blindly delegated to escrow companies who may not realize the significance of non-compliance. Thus, all parties to the agreement must be notified in writing of the assignment before the transfer of the property. Presumably, this means that all parties must receive written notice of the assignment before the transfer in order to be “notified.”

The exchange agreements in the TAM also failed to comply with the QI safe harbor because they did not expressly limit the taxpayers’ rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property before the end of the exchange period (or other “(g)(6)” event). See Reg. Section 1.1031(k)-1(g)(6). The taxpayers argued that they substantially complied with this requirement and that, as a practical matter, the sales proceeds held by the QI could only be used to acquire like-kind property - other real estate - under the exchange agreements. But the agreements merely provided that the QI agreed to convey to the taxpayers real estate “to be determined” and personal property “to be determined,” and contained no express limitation on the use to be made of the sale proceeds.

The taxpayers also pointed to language in an addendum and an amendment to the exchange agreements. The addendum included a provision that gave the QI the “option of paying” in cash to the taxpayers any remaining balance of the exchange equity not used to acquire replacement property on an unspecified date after the identification period. The

amendment included a direction to the QI to acquire the replacement property that was ultimately transferred to the taxpayers. The IRS stated: “These documents all show a clear intent to complete some sort of exchange. The Accommodator was plainly limited in discretion as to the use of the exchange proceeds and property. However, there were no [express] limits as to Taxpayer’s access to or use of the proceeds of the relinquished properties. Absent such limitations, there is no applicable safe harbor.”

Again, this problem could have been easily avoided. All the parties needed was a proper exchange agreement containing the talismanic words required by Reg. Section 1.1031(k)-1(g)(6). It is an absolute requirement of the QI safe harbor that the written agreement between the taxpayer and the QI expressly limit the taxpayer’s rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the QI as provided in paragraph (g)(6). See Reg. Section 1.1031(k)-1(g)(4)(ii). The exchange agreement should literally contain these words to avoid any ambiguity or doubt. For whatever reason, whether it be ignorance, old documents or plain sloppiness, the parties used vague exchange agreements that failed to comply with the QI safe harbor.

The final part of the TAM is the most controversial. The IRS stated: “With respect to safe harbors generally, if a safe harbor is not effective in a given transaction, the Service must characterize the transactions in accordance with their substantial character. In this case, the transactions appear to be more in the nature of a series of interrelated purchases and sales of real property, sold and acquired by Taxpayers H and W with assistance of Accommodator serving as their agent or nominee.” But the IRS cites no authority and gives no detailed analysis supporting

its conclusion that the QI was merely the taxpayers' agent or nominee. In fact, that conclusion may be at odds with a line of cases decided under Section 1031 and other authorities on agency. See Appendix B. Granted, the transaction described in the TAM is not within the QI safe harbor, but that does not necessarily mean that the QI was acting as the taxpayers' agent or nominee, or that the transaction was not in fact an "exchange" of property.

Compliance with one or more of the four safe harbors in the deferred exchange regulations ensures that the taxpayer avoids being considered in actual or constructive receipt of money or other property for purposes of an exchange. Reg. Section 1.1031(k)-1(g)(1). The IRS will not challenge transactions within the safe harbors. The regulations do not state, however, that a taxpayer will be automatically deemed to have actual or constructive receipt if the exchange does not comply with the safe harbors. The introductory explanation to the proposed regulations warns that transactions failing to come within any of the safe harbors will be "carefully scrutinized." But that does not mean that such transactions are taxable. It only means that the taxpayer must satisfy the requirements described in case law for a good exchange.

Further, the deferred exchange regulations do not supersede existing case law on actual or constructive receipt. Instead, Reg. Section 1.1031(k)-1(f)(2) incorporates the general rules concerning actual and constructive receipt and states that actual or constructive receipt by an agent of the taxpayer (determined without regard to the disqualified person rules) is actual or constructive receipt by the taxpayer. Thus, case law determines both whether the taxpayer is in actual or constructive receipt and whether an intermediary is the taxpayer's agent when the safe harbors are not satisfied.

In several decisions before enactment of the regulations, the courts upheld exchanges that

would not have qualified under any of the regulatory safe harbors. For example, the courts upheld the validity of an exchange in which an attorney or an attorney-owned corporation acted as intermediary to facilitate a tax-deferred exchange. See, e.g., Biggs v. Commissioner, 632 F.2d 1171 (5<sup>th</sup> Cir 1980); Coupe v. Commissioner, 52 T.C. 394 (1969) acq in result only 1970-1 C.B. xv. Those intermediaries would not have satisfied the disqualified person rules under Reg. Section 1.1031(k)-1(k)(2). See also the cases on agency above and Appendix B.

The TAM does not consider any of the applicable case law on exchanges or any of the authorities on the issue of agency. Compare PLR 200111025 (3/16/01) (applying the Section 1031 case law and the Supreme Court’s agency analysis to a non-safe-harbor reverse exchange). The TAM simply cites the same two failures to comply with the QI safe harbor - the lack of express limitations on the use of exchange funds (more accurately, the lack of the magic words) and the lack of written notice of the assignments - to reach an entirely conclusion: namely, that the QI was the taxpayers’ agent and the transaction was not an exchange. Such an analysis wrongfully transforms the requirements of a purported “safe harbor” into requirements of substantive law. If this issue alone were litigated, the taxpayers stand a reasonable chance of prevailing on these facts (as messy as they are) since the QI was probably not the taxpayer’s agent under existing case law.

**PLR 200211016 (3/15/02) Receivership of QI: No Suspension of 180-day Period.** In this ruling, a taxpayer suffered the misfortune of his QI going into receivership shortly after receiving the sale proceeds from the relinquished property. A state agency took possession and control of the QI, appointed a receiver, and filed a lawsuit against the QI. A judge later confirmed the appointment of the receiver and froze all assets of the QI, including the proceeds

from the sale of the taxpayer's relinquished property. The taxpayer timely identified replacement property by sending a designation form to the receiver of the QI and entered into a contract to purchase that property. But the taxpayer was prevented from purchasing the property within 180 days after the transfer of the relinquished property because the sales proceeds continued to be frozen as part of the receivership proceeding against the QI.

The taxpayer ingeniously requested a ruling that the 180-day period of Section 1031(a)(3)(B) is suspended for the duration of the receivership based on Section 6503(b) of the Code. Section 6503(b) provides that where the assets of the taxpayer are in the custody or control of a court the running of the period of limitations for collection is suspended for the duration of such control or custody and for six months thereafter. Not surprisingly, the IRS ruled that Section 6503(b) is not on point and cannot be relied on to suspend the 180-day period under Section 1031(a)(3)(B) where a taxpayer's assets are within court custody or control. The IRS cited Christensen v. Commissioner, 142 F.3d 442 (9<sup>th</sup> Cir. 1998) (unpublished opinion), aff'g T.C. Memo 1996-254. Christensen held that nothing less than literal compliance with Section 1031(a)(3)(B) satisfies the Congressionally-mandated deadline. See also Knight v. Commissioner, T.C. Memo 1998-107 (180-day period not extended if circumstances beyond taxpayer's control prevent acquisition of replacement property); St. Laurent v. Commissioner, T.C. Memo 1996-150 (replacement property acquired after 180-day period cannot qualify under Section 1031).

The argument was a "good try" by the taxpayer but he was met with more bad luck. The taxpayer had to recognize the gain on the exchange (subject to possible installment sale reporting), pay the tax, and wait to recover whatever sales proceeds he could at the end of the

receivership. What could the taxpayer have done to avoid this problem? First and foremost, the taxpayer should have selected a financially reliable QI. See Cuff, “Deferred Exchanges and How To Become a Millionaire” 27 J. Real Est. Tax 324 (Summer 2000). The taxpayer could have also used a qualified escrow account or qualified trust account to hold the exchange funds. The sales proceeds might not have been frozen, depending on the scope of the judge’s order.

Even if the sales proceeds were frozen, a well-heeled taxpayer could have advanced an amount equal to the sales proceeds to acquire the replacement property. It is possible that a receiver of the QI (or the QI itself) would agree to accept an assignment of the taxpayer’s rights to acquire the replacement property in order to complete the exchange. In that case, the taxpayer could argue that he made a good exchange and that the cash paid to acquire the replacement property offsets any cash received at the end of the receivership. See Rev. Rul. 72-456, 1972-2 C.B. 468 (money paid out in connection with an exchange offsets money received in the case of money used to pay brokerage commissions); Biggs v. Commissioner, *supra*; former Prop. Reg. Section 1.453-1(f)(1)(iii). Compare the anti-abuse rule of Reg. Section 1.1031(k)-1(j)(3), Example 2 (cash received is not offset by cash subsequently paid out in an exchange).

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### **Installment Sales and the Bona Fide Intent Requirement.**

Smalley v. Commissioner, 116 T.C. No. 29 (2001) is the first reported case to address the bona fide intent requirement of Reg. Section 1.1031(k)-1(j)(2)(iv). The rules coordinating installment sales under Section 453 and the safe harbors for deferred exchanges do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer is treated as having a bona fide intent only if it is “reasonable to

believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period.” If the taxpayer has such a bona fide intent, a transaction that straddles tax years will qualify for installment sale reporting, even though the exchange fails and the safe harbors are used.

The essential facts of the case are as follows. On November 29, 1994, the taxpayers (husband and wife) transferred rights to cut and remove timber on their land for a term of 2 years in consideration of \$517,076. The taxpayers and the buyer entered into an exchange agreement. They also entered into an escrow agreement with an escrow agent. The escrow agent was an attorney, performed no services for the taxpayers during the 2-year period preceding November 29, 1994, and was not related to the taxpayers. The net proceeds were paid to and held by the escrow agent pursuant to these agreements. The escrow agreement provided that (1) the escrow agent would apply the funds to purchase property designated by the taxpayers as directed by the buyers; (2) title to the replacement property will be acquired in the name of the escrow agent, as agent for the purchaser, and then conveyed by the escrow agent to the taxpayers (but this position also authorized the use of direct deeding); (3) “in no event shall Seller [the taxpayers] have use or control of the funds contained in escrow on or before termination of said escrow”; and (4) “Seller [the taxpayers] shall not have the right to sell, assign, transfer, encumber or in any other manner anticipate or dispose of his interest in said escrow until the same is actually paid over to and received by Seller.” It is not clear from the court’s opinion how or when the escrow could be terminated.

The taxpayers subsequently identified three replacement properties (fee interests in timberland) in the 45-day period by letters to the escrow agent. The escrow agent used the funds

to acquire the replacement properties, and title was transferred directly to the taxpayers in February and March 1995. The purchase of the properties exhausted all but \$205.45 of the escrow funds. This balance was paid to the taxpayers in May 1995.

The taxpayers were cash-basis taxpayers. They reported the transaction on their joint 1994 return, characterized it as a like-kind exchange of “timber” for “timber and land,” and deferred recognition of all of the gain under Section 1031. The IRS determined that the exchange did not qualify under Section 1031 since the properties were not of like kind. The IRS sent a notice of deficiency for the 1994 tax year stating that all of the gain had to be recognized in 1994 (the year of the sale). The IRS did not determine a deficiency for the 1995 tax year, and the statute of limitations had expired for 1995 shortly after the trial.

The court bypassed ruling on the like-kind issue and decided the case on the alternate ground that the taxpayers had a bona fide intent to effect an exchange in 1994. Thus, the taxpayers did not have actual or constructive receipt in 1994 (notwithstanding the use of a qualified escrow account to hold the funds), and could report the gain under the installment method. The court held that the gain was taxable (if at all) in 1995, not 1994.

In arguing that the taxpayers lacked the requisite bona fide intent, the IRS only disputed whether it was reasonable for the taxpayers to believe that they would acquire like-kind replacement property (as required by the regulation). The IRS claimed that the taxpayers always intended to acquire a fee interest in timberland and such property is not of like-kind to 2-year timber cutting rights. Thus, the IRS argued that the taxpayers never intended to acquire “like-kind” replacement property. The IRS did not contend that the taxpayers otherwise failed to

satisfy the bona fide intent test.

The court found this argument to be inconsistent with the regulation. The test is only whether it is “reasonable to believe” that like-kind replacement property will be acquired before the end of the exchange period. The court found that the taxpayers had a bona fide intent that the transaction would qualify for like-kind exchange treatment, taking into account that it constituted an exchange of realty for realty under Georgia state law. After discussing the relevant authorities under Section 1031 and Georgia state law, the court concluded that it was reasonable for the taxpayer to believe the such an exchange of standing timber for timberland would qualify under Section 1031. That suffices to meet the bona fide intent. Because of the posture of the case, it was unnecessary, and the court did not undertake, to resolve the issue of whether the like-kind requirement was in fact satisfied.

The court stated that “other relevant factors” indicated that the taxpayer had, at the beginning of the exchange period, a bona fide intent. These factors included: (1) The exchange agreement between the taxpayers and the buyer made the transaction conditioned upon “reasonable cooperation and a tax free exchange qualifying under Section 1031”; (2) the taxpayer used a qualified escrow account and a proper escrow agent as required by Reg. Section 1.1031(k)-1(g)(3); (3) the taxpayers identified and received the replacement properties within the 45-day and 180-day periods; (4) the taxpayer testified credibly that he intended to have a like-kind exchange; (5) in planning the transactions, the taxpayers relied on advice from a well-known timber taxation expert and his long-time accountant; and (6) the IRS did not determine any negligence or accuracy-related penalties, from which the court inferred that the IRS did not dispute that taxpayers had reasonable cause and acted in good faith.

The IRS blew this case. A similar issue arose in Christensen v. Commissioner, T.C. Memo 1996-254 (1988 transfer of relinquished property was entitled to installment sale treatment and gain was taxable in 1989 when replacement properties were received after the Section 1031(a)(3)(B) deadline). The taxpayers raised the alternative argument for installment sale treatment for the first time on brief. The 3-year limitations period for the 1995 tax year ran shortly after the trial date and shortly before the date the IRS received a copy of the taxpayers' brief. But the court found that the IRS had fair warning of the "receipt issue" before and during trial. The taxpayers consistently claimed that in 1994 they never received or had access to or control over any money incident to the exchange. If prejudice to the IRS arose, the court found that "it is of respondent's own making."

In addition to sending a notice of deficiency for the 1995 tax year to avoid being whipsawed, the IRS might have more closely scrutinized the escrow agreement in this case. The escrow agreement did not contain the precise "magic words" required by Reg. Section 1.1031(k)-1(g)(6). Arguably, the account was not a "qualified escrow account," although the court found that it was. The escrow agreement did have language that may have prevented actual or constructive receipt until the termination of the escrow, but it was unclear how or when the escrow could be terminated.

If the bona fide intent is not met and funds are held in an escrow account, or if the test is met but the account is not a qualified escrow account, case law under Sections 451 and 453 must be consulted to determine whether the taxpayer has actual or constructive receipt in the year of the sale, or whether the taxpayer qualifies for installment sale reporting. As the Tax Court pointed out in Griffith v. Commissioner, 35 T.C. 882, 892 (1961), the doctrine of constructive

receipt will be sparingly applied and should be invoked only in a clear case. In Willits v. Commissioner, 50 T.C. 602, 612-613 (1968), the Tax Court outline the theory of constructive receipt as follows: “The theory of constructive receipt is one of long standing, and regulations embodying that concept have had judicial approval as far back as Loose v. United States, 74 F.2d 147 [14 AFTR 813] (C.A. 8, 1934). Thus, although income is not actually reduced to a taxpayer’s possession, it is treated as constructively received by him in the taxable year when it is set apart for him, or otherwise made available to him without substantial limitation or restriction. Stated differently, a taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it. [Citations omitted.] On the other hand, a bona fide contract providing for deferred payment . . . [will] be given effect notwithstanding that the obligor might have been willing to contract to make such payments at an earlier time.” [Citations omitted.] See also Reg. Section 1.451-2; Rutland v. Commissioner, T.C. Memo 1977-8.

In Reed v. Commissioner, 723 F.2d 138 (1<sup>st</sup> Cir 1983), the court held that an escrow arrangement was effective to shift income recognition by the taxpayer for purposes of Section 451 when three conditions were satisfied:

- (1) The escrow arrangement was part of a bona fide arm’s-length agreement between the purchaser and seller, calling for deferred payment;
- (2) The seller received no present beneficial interest from the funds while they were in escrow (e.g., interest earned on the funds); and
- (3) The escrow holder was not acting under the exclusive authority of the taxpayer.

The court determined that substantial restrictions on access to the impounded funds had been imposed by both parties (not just the taxpayer), preventing constructive receipt by the taxpayer. See also Busby v. U.S., 679 F.2d 48 (5<sup>th</sup> Cir. 1982) ; Vaughn v. Commissioner, 87 T.C. 164 (1986); Stiles v. Commissioner, 69 T.C. 558 (1978), acq. 1978-2 C.B. 3.

The escrow agreement in Smalley appeared to satisfy this test, although it was unclear how interest on the funds were treated. But the three-part test in Reed may not be satisfied in a deferred exchange if the escrow holder holds the funds at the request of and under the exclusive authority of the taxpayer rather than for the buyer of the relinquished property. Unless the facts (rather than merely a recitation in the contract without legal or economic substance) show that the escrow holder holds the funds for the buyer of the relinquished property, a court may find that the impound of the funds is a self-imposed limitation directed by the taxpayer. See, e.g., Hillyer v. Commissioner, T.C. Memo 1996-214 (escrow was “fascade” and escrow account had no express limitations); Klein v. Commissioner, T.C. Memo 1993-491; Maxwell v. U.S., 88-2 U.S.T.C. Par. 9560 (S.D. Fla. 1988).

The rules provided in the deferred exchange regulations on actual or constructive receipt relate only to issues of actual or constructive receipt in deferred exchanges under Section 1031. These rules are not intended to be used in determining actual or constructive receipt for any other purpose. See Reg. Section 1.1031(k)-1(n). This implies that the IRS does not intend to affect the case law under Sections 451 or 453 if the bona fide intent test is not met or the safe harbors do not apply.

### **Related Party Exchanges**

TAM 200126007 (6/29/01) involved sales of replacement property by a related party in a

four-party simultaneous exchange involving the taxpayer, unrelated purchasers and a QI. The taxpayer did not recognize the gain realized on the exchange of the relinquished property. The related party reported the gain on the sale of one replacement property and deferred the loss on the sale of the other replacement property under Section 267(f). The taxpayer and related party, viewed as a group, reduced its investment in real estate. The taxpayer's low-basis residential properties were disposed of in the exchange. If Section 1031 applied to the exchange, the taxpayer's basis would be shifted to the replacement property previously owned by the related party. The sale proceeds of the taxpayer's relinquished property were received by the related party upon its sales of the replacement property and applied to reduce the related party's bank debt.

The IRS determined that the transactions fit squarely within Section 1031(f)(4) by shifting basis and cashing out investments through an exchange involving related parties. Accordingly, the exchange by the taxpayer was taxable under Section 1031(f)(4). The TAM is consistent with previous rulings applying Section 1031(f)(4) to transactions in which a related party sells the replacement property involved in a taxpayer's exchange. See TAM 9748006 (11/28/97); FSA 199931002 (4/12/99). See also Weller & Phillips "What's New in Like-Kind Exchanges" (NYU 57<sup>th</sup> Inst. Fed. Taxn. Bender & Co. 1999) (Section 14.03 Related Party Exchanges); Phillips & Rocca "Related Party Exchanges: What Works, What Fails and What Remains Uncertain" (11<sup>th</sup> Annual NRDC Conference 1998).

The taxpayer made a number of arguments to avoid the application of Section 1031(f)(4), all to no avail. The taxpayer first argued that Section 1031(f)(4) is limited to circumstances in which a direct exchange with a related party and subsequent disposition would have been

feasible. The taxpayer contended that various business and market imperatives made a direct exchange impractical since it would have created problems for the buyers and for the lender on the replacement property, and may have subjected the taxpayer's shareholders who were on the related party's board of directors to conflict of interest charges.

But the IRS responded that Section 1031(f)(4) denies Section 1031 nonrecognition treatment to ANY exchange which is part of a transaction structured to avoid the purposes of Section 1031(f). The exchange need not be a direct exchange with a related party. A position that Section 1031(f)(4) only applies in circumstances where a direct exchange and subsequent sale would have been feasible "would unwarrantedly restrict the application of Section 1031(f)(4) on the basis of circumstances that have little, if any, relationship to the purposes of that Section" and "there is no authority for such a position." Thus, the feasibility of a direct exchange is irrelevant and not a criterion for the application of Section 1031(f)(4). The IRS also found that a direct exchange was possible in this case, especially in light of the interdependence and simultaneity of the transactions.

The taxpayer also argued that Section 1031(f) is limited to circumstances that involve a direct or indirect related party exchange, and does not apply to a related party's sale to a QI. The IRS responded: "The purpose of Section 1031(f)(4), as indicated in the legislative history, is to deny nonrecognition treatment to any exchange (other than direct exchanges specifically addressed in Section 1031(f)(2)) that is part of a transaction (or series of transactions) which involves related parties and is structured to avoid the purposes of Section 1031(f), e.g., denial of nonrecognition treatment for any exchange that is part of a transaction (series of transactions)

that involve[s] basis shifting, ‘cashing out’ of an investment, reduction or avoidance of gain, or acceleration of losses.” The example in the Senate Finance Committee Report also indicates that reordering the sequence of transactions will not place the transactions beyond the scope of Section 1031(f)(4).

If the application of Section 1031(f) were limited as suggested by the taxpayer, the provision would be meaningless since its application could be easily circumvented by using an intermediary. But the use of an intermediary to avoid tax on the disposition of a taxpayer’s low-basis property and the intermediary’s application of the sales proceeds to purchase replacement property from a related party facilitates avoidance of the purposes of Section 1031(f). Thus, Section 1031(f)(4) covers situations where there are related party sales rather than exchanges.

The taxpayer next argued that use of a QI, which is not considered an agent or the taxpayer under the safe harbors, should prevent a related party sale from being treated as a related party exchange. But the IRS pointed out that a QI cannot be used to circumvent the related party rules. The same point was made in TAM 9748006 (which involved a taxpayer’s receipt of replacement property from his mother through a QI). See also FSA 199931002. In particular, the use of the QI safe harbors of Reg. Sections 1.1031(b)-2 and 1.1031(k)-1(g)(4) do not preclude the application of Section 1.031(f)(4). The QI safe harbors specifically provide that the QI will not be considered the agent of the taxpayer for purposes of Section 1031(a). The IRS noted that “the characterization does not apply for purposes of section 1031(f).”

The taxpayer also argued that the non-tax avoidance exception of Section 1031(f)(2)(C) should apply to its exchange and that the term “avoidance” of federal income tax does not

encompass otherwise legitimate tax deferral under Section 1031. By its terms, Section 1031(f)(2)(C) only exempts subsequent dispositions under Section 1031(f)(1)(C) in direct exchanges if it is established to the satisfaction of the IRS that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. The IRS found that even if the non-tax avoidance exception applied to the taxpayer's multiparty transactions for purposes of Section 1031(f)(4), the taxpayer had not established that tax avoidance was not one of the principal purposes of the exchange and/or the disposition of the taxpayer's relinquished property. The facts indicated that the related parties "cashed out" of an investment (the taxpayer's low-basis property) and there was basis shifting and reduction or avoidance of gain.

Further, the IRS noted that only the relationship of the parties is relevant to the application of Section 1031(f). The definition of related parties is provided in Section 1031(f)(3), and Section 1031(f) applies regardless of any evidence that might show that the parties are precluded from acting in collusion or otherwise deal at arm's length. Congress adopted only a limited set of exceptions in the form of Section 1031(f)(2). The TAM did not cite the legislative history relating to Section 1031(f)(2) and its inclusion of three examples of non-tax avoidance: certain exchanges of undivided interests, dispositions in nonrecognition transactions, and transactions that do not involve basis shifting. See PLR 199926045 (4/2/99) (ruling that Congress did not intend for Section 1031(f) to apply to a subsequent disposition in the 2-year period following an exchange of undivided interests). Based on the legislative history, a possible exception to Section 1031(f)(4) is a case where the related party transfers the

replacement property in its own Section 1031 exchange (i.e., doesn't sell the property but rather disposes of it in a nonrecognition transaction). In that event, neither party "cashes out" in the 2-year period.

Finally, the taxpayer desperately contended that Section 1031(f)(4) must distinguish between cases that are the result of tax planning, such as the taxpayer's case, and those that are the result of abusive tax avoidance, i.e., cases that would not qualify as Section 1031(f)(2)(C) exceptions. But the IRS instead used the taxpayer's admitted tax planning as evidence that the transactions were "structured" to avoid the purposes of Section 1031(f). The structure of the transactions was driven by the intent of the taxpayer and related party to "cash out" of some of the taxpayer's appreciated properties without tax in order to reduce the related party's debt without the necessity of an additional capital contribution or loan from the taxpayer. The IRS also noted that "if tax planning were a basis for exception from anti-abuse provisions such as Section 1031(f), the provision would have no impact as many abusive transactions evidence significant and ingenious planning."

The IRS has consistently ruled that Section 1031(f)(4) applies to sales of replacement property by related parties in connection with a taxpayer's exchange. We are unaware of any reported exception. Taxpayers have tried all kinds of interesting arguments in TAM 200126007 and TAM 9748006 to avoid the application of Section 1031(f)(4) to such transactions, but all of these arguments have been rejected by the IRS. Some practitioners continue to assert that an acquisition of replacement property from a related party as a "back-up" in a deferred (not simultaneous) exchange might fall within Section 1031(f)(2)(C) if property from a third party cannot be acquired despite good-faith attempts to do so. Despite the logic of the IRS's position,

many taxpayers still want to receive replacement property that is sold by a related party. Some advisors allow them to do so, mistakenly thinking that interposing a QI will avoid Section 1031(f) or that the taxpayer has a good business reason or his case is otherwise so exceptional as to avoid Section 1031(f)(4). Don't believe it. The IRS surely doesn't.

FSA 200137003 (9/14/01) confirms that a sale more than two years after a like-kind exchange between related parties will not trigger gain recognition, either under Section 1031(f)(1) (which applies only to dispositions in the 2-year period after a direct exchange) or under Section 1031(f)(4) (which does not expressly contain a time limitation). The FSA reached this conclusion even though the related parties systematically liquidated adjacent properties and intended to dispose of the replacement property after the 2-year period.

The IRS noted that a taxpayer acquiring property from a related party can avoid application of Section 1031(f)(1) merely by waiting until after the 2-year period to dispose of the property. Thus, Section 1031(f)(4) does not apply to this situation because there was no attempt by either party to circumvent the rules. Rather, the parties merely took advantage of what Congress allowed them by enacting the 2-year rule. The IRS stated: "In our view, the purpose of Section 1031(f)(4) is to stop taxpayers from violating the two-year rule, and not to preclude taxpayers from planning to dispose of property after the two-year period."

The IRS pointed to the example in the legislative history which applied Section 1031(f)(4) to an exchange "within 2 years" after a disposition of the property. In that example, a related party sold the replacement property to a third party which was followed by an exchange of that property with the taxpayer in the 2-year period, pursuant to a prearranged plan. The IRS believed that "the key here is circumvention of the two-year rule, not a transfer with intent to

dispose after the expiration of the two-year waiting period.” The IRS cautioned, however, that this analysis would not apply if the exchange were a sham. See also Section 1031(g) (tolling the 2-year period if the taxpayer enters into a sales contract, option or similar arrangement substantially diminishing its risk of loss during the 2-year period). Thus, if there were any serious fears that the IRS would apply Section 1031(f)(4) to these situations, the FSA should alleviate them.

### **Multiple Property Exchanges and Contingent Liabilities**

\_\_\_\_\_ PLR 200208004 (2/22/02) might be overlooked as a ruling applicable only to a special industry ---- nuclear power and electric generating plants. Part of the ruling addresses an issue under Section 468A relating to the transfer of qualified nuclear decommissioning funds, which will not be discussed here. But the ruling goes on to address the treatment of contingent liabilities in a multiple property exchange, and it is the first ruling to do so. Practitioners previously speculated on the different approaches that might be used to account for contingent liabilities in a Section 1031 exchange. See Platner, “Special Issues Involving Liabilities in Section 1031 Exchanges,” 17 Real Est. Tax Digest 55 (February 1999), reprinted (12<sup>th</sup> Annual NRDC Conference 1999). Specifically, the questions are whether such liabilities should be taken into account for purposes of applying the liability-netting rules and determining gain and basis. Should such liabilities be taken into account at least to the extent they are reckoned with economically by the parties to the exchange, even though the ultimate amount of such liabilities is not known with certainty at the time of the exchange?

The IRS has now provided some guidance on these issues. The ruling relates to service liabilities to decommission nuclear power plants at the end of their useful lives, but the principles used by the IRS should apply to other contingent liabilities. The IRS found that a decommissioning liability should be taken into account as a liability assumed by the transferee for purposes of applying the liability-netting rules, allocating excess liabilities assumed to exchange groups (but not the residual group) with the potential of creating deficiencies (i.e., boot) in the exchange groups, and thereby determining realized and recognized gain under Reg. Section 1.1031(j)-1(b). But the IRS also ruled that such a liability should not be taken into account for purposes of determining basis in the replacement property under Reg. Section 1.1031(j)-1(c) unless and until economic performance occurs with respect to the liability (i.e., costs are incurred in satisfaction of the liability, including the performance of services relating to a decommissioning liability).

The simplified facts of the ruling are as follows. Company 1 owned an undivided interest in power plants and wanted to sell its generating assets. Company 2 was the owner of the other interests in the plants and wanted to exchange other generating assets for Company 1's interest in the plants. Company 2 intended that the exchange would qualify under Section 1031, although no ruling was requested on this issue. Company 1 will treat the transaction as taxable because it will immediately sell at auction all of the generating assets received from Company 2 in the exchange, and not hold such assets for business or investment purposes. Company 2 will assume all liabilities of Company 1 associated with decommissioning the plants. The assets involved in the exchange included an undivided interest in the tangible and intangible real and personal property associated with the undivided interest in the plants (footnote 1 of the ruling describes

the different types of assets). The ruling does not consider whether the interests may be interests in a tax partnership or whether a Section 761(a) election was made to exclude the interests from Subchapter K.

The most interesting part of the ruling is the tax analysis of the decommissioning liabilities. With respect to Company 1 (which is relieved of such liabilities), the IRS held that Company 1 is entitled to a deduction under Reg. Section 1.461-4(d)(5) with respect to the amount of the decommissioning liability that is included in the amount realized by Company 1 as a result of the transfer of its interests in the plants. Thus, the relief of such liability would increase Company 1's gain but also provide an offsetting deduction. It is important to understand the tax treatment of the decommissioning liability with respect to Company 1, although it simply engaged in a taxable disposition of its assets. The tax treatment of Company 2, which assumed the decommissioning liability in the multiple property exchange, parallels the treatment of Company 1. Company 2 had to take the liability assumed into account for purposes of determining gain realized and recognized on the exchange, but could not include the liability in basis until its own economic performance occurred.

The amount of liabilities assumed under Section 1031 is determined by Section 357(d). Section 357(d) provides rules for determining whether recourse or nonrecourse liabilities are assumed based on who has agreed to and is expected to satisfy a recourse liability or who receives assets subject to a nonrecourse liability. On its face, Section 357(d) may apply to a liability even if the ultimate amount of the liability is not known with certainty. Section 357(d)

provides as follows with respect to liabilities:

1. A recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability; and

2. A nonrecourse liability shall be treated as having been assumed by the transferee of any asset subject to such liability; except that the amount of a nonrecourse liability shall be reduced by the lesser of (1) the amount of such liability which an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to, satisfy; or (2) the fair market value of such other assets (determined without regard to Section 7701(g) which provides that the fair market value equals the amount of the nonrecourse debt).

**Treatment of Company 1.** With respect to Company 1's ability to deduct the liability, the Service began its analysis with the general rules requiring economic performance. Reg. Section 1.446-1(c)(1)(ii)(A) provides that under the accrual method of accounting, a liability is incurred and generally taken into account for federal income tax purposes in the year in which (i) all the events have occurred that establish the fact of the liability, and the amount of the liability can be determined with reasonable accuracy (the two prongs of the “all-events test”); and (ii) economic performance has occurred with respect to the liability (the “economic performance requirement”). See also Reg. Section 1.461-(4)(a)(1). Section 461(h)(2)(B) provides that in the

case of a liability that requires the taxpayer to provide services, economic performance occurs only as the taxpayer provides the services. Reg. Section 1.461-4(d)(4) provides that economic performance occurs with respect to such service liabilities as the taxpayer incurs costs in connection with the satisfaction of the liability.

Those are the general rules. But Reg. Section 1.461-4(d)(5) provides an exception to the general economic performance rules where the taxpayer sells a trade or business. Where the purchaser expressly assumes a liability arising out of the taxpayer's trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to the liability occurs as the amount of the liability is property included in the amount realized on the sale by the taxpayer. Accordingly, for Company 1 to deduct the liability, the liability only had to meet the all-events test and be included in the amount realized on sale.

The first prong of the all-events test requires that the fact of the liability be established at the time of the deduction. This prong of the test was satisfied because obligation arose many years ago, at the time Company 1 obtained its license to operate each of the plants. Generally, under federal and state tax laws, utilities that operate nuclear power plants are obligated to decommission the plants at the end of their useful lives. The second prong of the all-events test requires the amount of the liability to be reasonably determinable. See Reg. Section 1.461-1(a)(2)(ii). This prong was also satisfied because the amount of Company 1's decommissioning liability was determined by experts and reviewed by the Nuclear Regulatory Commission (NRC),

which is charged with ensuring that sufficient funds are available to decommission the plants. Given that the two prongs of the all-events test were satisfied, economic performance by Company 1 with respect to the decommissioning liability occurs as of the date of the transfer of assets to the extent that the liability is included in Company 1's amount realized. At that time, Company 1 is entitled to a deduction for the amount of its decommissioning liability under Reg. Section 1.461-4(d)(5).

Section 1001(b) provides that a seller's amount realized from the sale of property is the sum of any money received plus the fair market value of the property (other than money) received. Reg. Section 1.1001-2(a)(1) provides that a seller's amount realized from the sale of property includes the amount of liabilities from which the seller is discharged as a result of the sale. This may include secured and unsecured liabilities and debt and non-debt liabilities. For example, in Fisher Co. v. Commissioner, 84 T.C. 1319, 1345-47 (1985), the assumption of a lessee's repair liability was treated as part of the amount realized on the sale of a leasehold interest. Further, the decommissioning liabilities from which Company 1 will be relieved are fixed and determinable. As an owner and operator of nuclear plants, Company 1 is required by law to provide for eventual decommissioning. The fact of the liability was established, and the amount of the liability was reasonably determinable. Thus, the IRS held that the amount of Company 1's decommissioning liability is included in Company 1's amount realized.

**Treatment of Company 2.** The IRS ruled that, if the exchange of assets by Company 2 qualifies under Section 1031, the decommissioning liability assumed by Company 2 will be

taken into account in determining gain under Section 1031 and Reg. Section 1.1031(j)-1(b), but will not be taken into account in determining basis under Section 1031 and Reg. Section 1.1031(j)-1(c) until such time as economic performance occurs with respect to the liability. Thus, two different rules apply for purposes of determining (i) basis and (ii) gain.

The IRS noted that, as a general rule, the assumed decommissioning liability cannot be treated as “incurred” for any federal income tax purpose – including basis – until economic performance occurs with respect to that liability. Reg. Section 1.446-1(c)(1)(ii)(B) provides that the legislative history underlying the enactment of Section 461(h) makes it clear that Congress intended to exclude an item from being taken into account for tax purposes until economic performance occurs. The IRS stated that this treatment applies to capital and well as non-capital transactions, citing the legislative history. Despite criticism from some commentators that the IRS lacks authority to apply the economic performance rules broadly enough to include the calculation of basis and cost of goods sold, the IRS believes that the intended scope of the statutory provision is indeed broad enough to apply in this manner. Preamble to T.D. 8408, 57 Fed. Reg. 12411 (Apr. 10, 1992) [1992-1 C.B. 155, 156].

Consistent with this position, the IRS amended the regulations under Section 446 to clarify that a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which the all-events test is satisfied and economic performance has occurred with respect to the item. See Reg. Section 1.446-1(c)(1)(ii)(A). Under these regulations, “[t]he term ‘liability’ includes any item allowable as a deduction, cost, or expense for Federal income

tax purposes.” The regulations specifically cite the capitalization provisions of Section 263 as an example of a Code provision that is subject to the economic performance requirement.

Specifically, the regulations state that “an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property.” [Emphasis added.]

Thus, the question was whether the liability will be “incurred” as of the date of the transfer of the assets to Company 2. The IRS held that it will not. Economic performance does not occur with respect to a service liability such as the decommissioning obligation unless until and only to the extent that costs are incurred in satisfaction of that liability under Reg. Section 1.461-4(d)(4). Since Company 2 will not have performed any services relating to the decommissioning liability at the time of the transfer of the plants, economic performance will not have occurred. Accordingly, the IRS ruled that the liability will not have been incurred at that time for purposes of determining Company 2's basis under Section 1031.

Many cases have held that a taxpayer acquiring a property may not include any assumed “contingent” liabilities in basis. See, e.g., Pacific Transport v. Commissioner, 483 F.2d 209 (9<sup>th</sup> Cir. 1973) and Long v. Commissioner, 71 T.C. 1 (1978) (assumption of contingent liability only increases basis as payments on the liability are made). But not all “Contingent” liabilities can be ignored under this basic principle for other purposes. This includes nonrecourse debt in excess of a property's fair market value for purposes of determining the amount realized on sale, even though the excess liability might not ever be paid. See Section 7701(g), Tufts v.

Commissioner, 461 U.S.. 300 (1983) and Reg. Section 1.1001-2(a). From these authorities, one might have foreseen that two different standards could apply to contingent liabilities assumed in an exchange: one for determining basis and one for determining gain.

The IRS went on to note that a liability is not ignored for all tax purposes simply because of the fact that prior to economic performance a liability is not “incurred” and, thus, is not taken into account for the purpose of determining a taxpayer’s basis. Specifically, the enactment of the economic performance rules contained in Section 461(h) did not change the rules for determining when a liability is included in the calculation of amount realized under Sections 451 and 1001. This principle is reflected in Reg. Section 1.461-4(d)(5), in the context of relief from a liability as an amount realized. Reg. Section 1.461-4(d)(5) provides an exception to the economic performance rules in the case of the sale of a trade or business and makes clear that Section 461(h) does not determine the amount or timing of the taxpayer’s amount realized. Under Reg. Section 1.461-4(d)(5), economic performance occurs as the amount of the liability is properly included in the amount realized on the transaction by Company 1. The IRS stated that this language clarifies that the rules for determining whether and when the liability is “property included” in the amount realized are independent of Section 461(h). See the cross-reference to Reg. Section 1.1001-2 at the end of Reg. Section 1.461-4(d)(5)(i).

The all-events test in Section 451 requires income to be reported under an accrual method of accounting when (1) all the events have occurred which fix the right to receive the income and (2) the amount of income can be determined with reasonable accuracy. As indicated above, with

respect to Company 1, the IRS found that both prongs of the all-events test were met in this case with respect to the decommissioning liability. Similarly, the IRS found that meeting the all-events test was sufficient to cause the assumed liability to be taken into account for purposes of determining gain by Company 2.

Under the Section 1.1031(j) regulations, liabilities assumed are initially pooled, reduced by liabilities relieved, and then allocated among the exchange groups (but not to the residual group) to reduce the fair market value of properties received. This determines whether gain is recognized because of a “deficiency” in any exchange group. A “deficiency” arises if the fair market value of the properties transferred in that group exceeds the fair market value of the properties received in that group reduced by that group’s proportional share of any excess liabilities assumed. Boot is deemed to be received on the transfer of assets in that group to the extent of the deficiency. Gain must be recognized in an amount equal to the gain realized with respect to an exchange group or the amount of the deficiency, whichever is greater. See Reg. Sections 1.1031(j)-1(b) and 1031(j)-1(d), Example 4. The effect of the IRS’s ruling on Company 2 is that Company 2 may have to recognize gain as a result of assuming the decommissioning liabilities excess liabilities are assumed in the transaction and deficiencies are created in exchange groups.

The IRS concluded: “The specific issue addressed in, for example, Section 1.461-4(d)(5) – whether relief from a liability is included in amount realized – and the specific question addressed here – whether an assumed liability is taken into account in determining realized and recognized

gain under the Section 1.1031(j) regulations – are not identical. However, they both concern the effect of liability assumption on the calculations of amount realized . . . [T]he issue of whether a liability is taken into account in such a calculation is governed by the general principles of Section 1001 and Section 451, which do not require, at least in this context, that economic performance be satisfied.” Thus, the IRS ruled that the decommissioning liability should be taken into account for purposes of determining Company 2's gain on the exchange of property, but not for purposes of determining its basis in the replacement property.

Finally, the IRS addressed the question of the treatment of the liability when economic performance occurs. When additional amounts are paid or incurred by Company 2 for the assets received in the exchange (e.g., when the nonqualified decommissioning fund pays or incurs decommissioning expenses), such amounts will be taken into account as increases to Company 2's consideration in the exchange. These amounts will then be allocated “in the same manner and subject to the same conditions as though they were paid or incurred on the acquisition date,” including for purposes of the adjustments to basis contemplated by Reg. Section 1.1031(j)-1(c). Although the amount of Company 2's basis in the replacement property will not include the amount of its assumption of the decommissioning liability at the time of the exchange, when economic performance is satisfied with respect to such liability, the amounts will be taken into account under Reg. Section 1.1031(j)-1(c) as though they were incurred on the exchange date. To the extent that the liability is not taken into account under Reg. Section 1.1031(j)-1(c) at that time, the amounts will be allocated to the non-like-kind property as though they were incurred on the exchange date.

This will result in a complicated recalculation of Company 2's basis in each asset received in the exchange. That recalculation would then prospectively affect Company 2's depreciation, amortization and gain or loss on the sale of the assets. It could also retroactively affect depreciation, amortization and gain or loss on sale, depending on what the IRS means when it says that the amounts are treated “as though they were paid or incurred on the acquisition date.” This is unclear. If adjustments may be made retroactively, amended returns may be filed at least for open years.

### **Leasehold Interests.**

In FSA 200205023 (10/24/01), the IRS dealt with a lease-in/lease-out (LILO) arrangement that the taxpayer entered into to avoid recognition of gain on an exchange under Section 1031. The IRS concluded that the LILO arrangement was a sham and should be disregarded for tax purposes. Through an intermediary, the taxpayer transferred its ownership interest in a culm-fired cogeneration plant at a gain. To defer the gain, the taxpayer leased an interest in an electric generating facility from a tax-exempt entity (“head lease”) and then leased the interest back to the entity under a sublease (“operating lease”). The taxpayer made an initial prepayment that included the proceeds of sale from the relinquished property and proceeds from a loan incurred by the taxpayer. The tax-exempt entity used the prepayment to invest in Treasury strips and pledged its interest to secure its payments to the taxpayer under the operating lease. The taxpayer used the pledge to secure the loan used to finance the prepayment. The taxpayer treated the LILO as a sale of a leasehold interest and leaseback, accounted for the transaction as a purchase, and claimed like-kind exchange treatment.

Using an economic substance analysis from several cases as well as Rev. Rul. 99-14, 1999-13 I.R.B. 3, the IRS concluded that the LILO transaction was a sham. As for the like-kind exchange, the IRS concluded that the transaction did not qualify for two reasons. First, the ownership of the replacement property could be classified as a tax partnership. In that event, the taxpayer only acquired a partnership interest that does not qualify for like-kind exchange treatment. Second, because the LILO transaction was a sham, the taxpayer never acquired a qualifying interest in property through the lease. Rather, the IRS ruled that the taxpayer's equity investment should be characterized as a loan to the tax-exempt entity or, alternatively, as if the taxpayer itself purchased and owned the Treasury strips through the tax-exempt entity. The IRS also found that original issue discount income should be imputed to the taxpayer under either of these alternatives, and that the taxpayer lacked reasonable cause for its tax treatment of the transaction and accuracy-related penalties should be imposed.

The IRS has taken the position that certain LILO transactions lack economic substance. See Rev. Rul. 99-14, supra. When the form of the transaction lacks economic substance, the form is disregarded and the proper tax treatment is determined consistent with the substance of the transaction. The IRS stated that a sale leaseback transaction is distinct from a LILO transaction. A LILO involves a lease from one entity to another, with a generally coextensive lease back to the first entity. A sale leaseback involves a disposition for tax purposes, and not merely the granting of a lease. Rev. Proc. 75-21, 1975-1 C.B. 715, provides safe harbors and ruling guidelines for determining whether a transaction is a lease or sale. Because a sale leaseback is distinct from a LILO transaction, Rev. Proc. 75-21 does not apply to LILO transactions. The IRS also stated that

an analysis of benefits and burdens factors, as would be used in analyzing a sale leaseback, would be inappropriate with respect to LILO transactions. Rather, the test is whether the LILO transaction has economic substance separate and apart from the economic benefit achieved solely by tax reduction.

The IRS concluded that the objective facts of the LILO transaction indicated that it lacked the potential for any significant economic consequences other than the creation of tax benefits. As in Rev. Rul. 99-14, the cash flows in the LILO transaction were completely circular in nature. The proceeds of the taxpayer's loan for the prepayment of rent under the head lease were transferred to tax-exempt entity and were then immediately deposited with an affiliate of the taxpayer's lender. The deposit earned an interest rate equal to that paid on the taxpayer's loan. The lender will use the deposit plus interest to pay the tax-exempt entity's rent obligation under the operating lease, as well as a portion of its initial installment of the purchase option to buy back the taxpayer's interest under the head lease at the end of the term of the operating lease. In this way, all of the payments due under the operating lease were fully set aside as of the closing date of the LILO transaction. Moreover, with the exception of the minimal risk associated with the taxpayer's loan, the taxpayer eliminated all potential risks of loss that may result from the transaction.

In addition, the various options at the end of the operating lease presented insignificant, if any, economic risk to either party. The terms of the option, the tax-exempt entity's interest in retaining ownership and use of the plant, the accounting for the transaction, and the reservation of

funds to fully pay the purchase option price at the start of the transaction, all indicated that exercise of the purchase option was the most likely choice for the lessee. The purchase option acted as an “economic collar” which, when exercised, completed the circular flow of funds.

The IRS also found the net present value of the taxpayer’s equity investment absent any tax benefits showed an insignificant rate of return compared to the return with tax benefits. See, e.g., Hines v. Commissioner, 912 F.2d 736 (4<sup>th</sup> Cir. 1990) (lease transaction was sham and court noted that \$17,000 profit potential was “minimal” on an eight-year investment of \$130,000). The Fourth Circuit in Hines also found evidence of tax motivation in the offsetting obligations to pay rent and debt service and stated that “the tax tail began to wag the dog.” Thus, the IRS stated that small profits on a lease transaction may be overlooked when tax considerations have taken over the transaction. Based on the circular flow of funds, the minimal risk associated with the LILO transaction, and the lessee’s incentive to purchase the property, the IRS concluded that the transaction lacked economic substance and should be disregarded for federal income tax purposes.

The IRS also noted that certain documents characterized the relationship of the owners of the replacement property as joint venturers. The undivided interest in the property that the taxpayer acquired for purposes of effectuating the like-kind exchange was acquired from only one of the co-owners of the plant. As a joint venture, the ownership interests in the property would be partnership interests for federal tax purposes, unless the owners elected out of Subchapter K under Section 761(a). In applying the three-part test of Section 1.761-2(a)(3) to the property, the owners appears to satisfy the first two prongs. The ownership agreement executed by the owners stated that the owners own the property as tenants in common and that each participant reserves the right

to take in kind or dispose of their shares of power produced. However, the ownership agreement also provided that excess electrical power not needed by the owners shall be pooled and offered for sale, with each owner credited a proportionate share of the revenue from the sale. The IRS stated that this provision likely violates the requirement under Reg. Section 1.761-2(a)(3) that the co-owners do not jointly sell the property produced. Thus, regardless of whether or not the owners actually elected out of Subchapter K, the IRS found it unlikely that they were eligible to do so.

If the electric generating plant is owned and operated as a tax partnership, the property acquired by the taxpayer (the interest in the head lease, presumably with a term of 30 or more years) would be treated as a partnership interest. Section 1031(a)(2)(D) would preclude the taxpayer from using Section 1031 to defer its gain on the disposition of the relinquished property. Even if the interest acquired by the taxpayer did not constitute a partnership interest, replacement property must be actually acquired by the taxpayer. This acquisition could be accomplished either by purchase or through a lease with a term of at least 30 years. But the IRS concluded that since the LIFO transaction lacked economic substance and should be disregarded, replacement property was not actually acquired by the taxpayer. Thus, in either of these cases, Section 1031 nonrecognition would not be available to the taxpayer.

**Like-Kind Rules for Leasehold Interests.** The facts of FSA 200205023 involve an interesting attempt to use split ownership and leasehold interests in connection with an exchange. Acquiring a long-term leasehold interest as replacement property in an exchange may provide a

variety of legal, financial, accounting, and tax benefits, including estate tax benefits. For example, the fee interest may be purchased for cash outside of the exchange by the taxpayer's heirs so that the residual value of the property is not included in the taxpayer's gross estate. The taxpayer can still defer capital gains taxes by acquiring a long-term leasehold interest in the exchange. At the same, the taxpayer can minimize the amount ultimately included in his gross estate (i.e., the value of the leasehold interest at date of death).

Under long-standing regulations a fee in land is of a like kind to a leasehold of land with a remaining term of 30 years or more. See Treas. Reg. Section 1.1031(a)-1(c)(2); Century Electric Co. v. Commissioner, 192 F.2d 155 (8<sup>th</sup> 1951), cert. denied, 342 U.S. 954 (1952) (fee for 95-year lease in same property). If the lease provides for optional renewal periods, they are included in determining whether the leasehold has 30 years or more to run. R & J Furniture Co. v. Commissioner, 20 T.C. 857 (1953), 1954-1 C.B. 6 (lease with initial term of 5 years and ten optional renewal periods of 5 years each held to be of like kind to a fee since the taxpayer had the right to use the property for up to 55 years); Rev. Rul 78-72, 1978-1 C.B. 258 (leasehold interest with initial term of 25 years and three 10-year renewal periods held to be of like kind to a fee since the optional renewal periods are included for purposes of the 30-year requirement. It is unclear if a lease with less than 30 years to run can be extended to beyond 30 years and then exchanged by the lessee for a fee. The lessee may not have held like-kind interest for the requisite holding period if the lease is extended immediately before the exchange. However, a taxpayer should be able to exchange a fee for a leasehold of 30 years or more if the seller of the leasehold extends the term to beyond 30 years immediately before the exchange to meet the taxpayer's

exchange requirements.

Different kinds of leasehold interests may be involved in an exchange. The taxpayer may receive as replacement property a pre-existing leasehold in property where the taxpayer already owns the fee or other reversionary interest. The taxpayer may exchange the fee interest in relinquished property for a long-term leasehold as replacement property in the same property. See Rev. Rul. 68-394, 1968-2 C.B. 338. The taxpayer can transfer a fee for the receipt of a newly or recently created leasehold interest with 30 years or more to run. See Rev. Rul. 66-209, 1966-2, C.B. 299; PLR 9110007 (11/26/90). However, the granting of a new lease by a taxpayer-lessor in exchange for property is not treated as like-kind exchange, but is treated as the receipt of advance rental income by the taxpayer-lessor in an amount equal to the equity value of the property received. Pembroke v. Helvering, 23 B.T.A. 1176 (1931), aff'd. 70 F.2d 850 (D.C. 1934); Crooks v. Commissioner, 92 T.C. 816 (1989).

It may be possible to avoid the result in Pembroke and Crooks by granting a lease to a related entity and having the related entity exchange the leasehold interest for real property. This was done in PLR 9110007 by the fee owner of the replacement property, but the fee owner was not the taxpayer-exchanger requesting the ruling. The step-transaction doctrine may also apply to a taxpayer-lessor attempting to avoid prepaid rent in this way. On the other hand, a lessor can make a Section 1031 exchange of his reversionary interest in leased property (the relinquished property) while retaining the rental interest in the relinquished property for the term of the lease. PLR 9224008 (3/6/92). The problem presented by Pembroke and Crooks (i.e., the granting of a

lease is not a sale or exchange by the lessor) is not present if a taxpayer receives a newly created lease as the lessee. Further, if an accommodator enters into a newly created lease, the exchange that counts is the exchange between the accommodator and the taxpayer, which will involve an existing leasehold interest.

By negative implication from the example in the regulations, if a leasehold has an unexpired term of less than 30 years, it is not of like kind to a fee. See Rev. Rul. 83-70, 1983-1 C.B. 189 (15-year leasehold not of like kind to a fee); PLR 8319011 (leasehold in motel property with 23 years to run is not of like kind to a leasehold with a term of 30 or more years or a fee in other motel property). If short-term leasehold interests are exchanged for one another, it is unclear how similar the short-term leasehold interests must be. Compare Rev. Rul. 76-301, 1976-2 C.B. 241 (leasehold with about 27.5 years to run in 20 floors for sublease of identical term in 5 floors of the same building) with PLR 8319011 (leasehold in motel property with 23 years to run replaced by golf course leasehold with an unspecified term of less than 30 years). See also PLR 8004133 (leasehold with 15 years to run, when increased by an option to renew for 10 years, is similar to a lease with a term of 25 years for purposes of Section 1033(a)(3)(A)); Everett v. Commissioner, T.C. Memo 1978-53 (rights to remove timber on approximately 5,000 acres for three and six years under timber lease exchanged for rights to remove timber on approximately 24,000 acres for 10 years).

**Creating Value in a Leasehold.** Value in a leasehold interest may pre-exist or be created. If a long-term leasehold provides for an arm's length rental rate, it may qualify as replacement

property but it would have limited separate value. If an existing leasehold provides for a below-market rental rate, a significant value may be allocated to it. In a transaction with a QI, a taxpayer may direct the QI to enter into a long-term leasehold with the fee owner of replacement property and to use exchange funds to “prepay” a portion of the rent by way of a lease acquisition payment. Thereafter the QI can transfer the now below-market leasehold interest to the taxpayer to complete the exchange. The landlord will have ordinary income from prepaid rent. The same type of transaction can be structured with an EAT in a reverse exchange under the safe harbor provisions of Rev. Proc. 2000-37. Finally, a QI, an EAT, or another exchange accommodation party may enter into a long-term ground lease and then construct and own a building as a leasehold improvement. The value from the leasehold interest arises from the lessee’s tax ownership of the leasehold improvements.

**Build-to-Suit Exchanges Involving Leaseholds.** In PLR 9110007 (11/20/90) and PLR 9149018 (9/4/91), the IRS approved transactions in which an accommodator, prior to and in anticipation of an exchange, acquired a leasehold interest in land with 30 or more years to run and constructed improvements thereon to the taxpayer’s specifications. Each ruling holds that the taxpayer’s exchange of relinquished property for the accommodator’s leasehold in other land and the newly constructed building qualifies as a Section 1031 exchange. So long as the stated term of the acquired leasehold equals or exceeds 30 years, the leasehold and improvements will be treated as of like kind to a fee interest, even if the accommodator did not anticipate occupying the leased premises after the completion of the exchange. In PLR 9110007, the 51-year leasehold interest received in the exchange qualified as like kind property, even though it was subject to an

option held by the fee owner to buy back the leasehold and building if specified events occurred. Further, as long as the accommodator is not the taxpayer's agent, the case law has permitted taxpayers great latitude in supervising construction activities and bearing the risk of cost overruns in qualifying Section 1031 transactions. See, e.g., Boise Cascade Corp. v. Commissioner, 33 T.C.M. 1443 (1974).

Use of QIs and EATs. In a deferred exchange in which a QI enters into a long-term lease, constructs improvements during the 180-day period, and thereafter transfer the leasehold interest and leasehold improvements to the taxpayer, the transaction should comply with the requirements of the QI safe harbor. By entering into a lease of 30 or more years, the QI will acquire a fee-equivalent interest in the replacement property. By entering into the relevant construction contracts and making the required payments thereunder, the QI will become the legal owner of the leasehold improvements. The QI will ultimately transfer legal title to the leasehold interest and leasehold improvements to the taxpayer by way of appropriate assignments and other instruments of transfer. Since the QI will acquire and transfer legal title to the leasehold interest and the leasehold improvements in a "safe harbor" transaction, it should not be necessary to consider whether the QI did so as the taxpayer's agent or otherwise maintained sufficient benefits and burdens of ownership under general tax principles.

The same result should be true for a QEAA with an EAT for a safe harbor "reverse" exchange. Rev. Proc. 2000-37 provides that so long as the EAT obtains "qualified indicia of ownership" and transfers the property to the taxpayer within 180 days, the IRS will not challenge

the treatment of the EAT as the beneficial owner of such property. Legal title to the leasehold interest and the leasehold improvements should satisfy the qualified indicia of ownership test.

Using a QI or an EAT to acquire a newly created lease may be problematic because the intermediary may be leery of becoming a party to and having obligations under a long-term lease. A solution might be for the fee owner to enter into a lease with the intermediary that could be assigned within six months to the exchanger, extinguishing all further liability of the intermediary thereunder, or alternatively, that could be cancelled after six months by the intermediary. The exchanger may be asked to guarantee some or all of the intermediary's obligations, and probably would need to indemnify the fee owner for demolition costs with respect to improvements made (or begun to be made) by the intermediary. In any event, a QI or an EAT will want to ensure that it is not fully liable for the entire term of the lease after the assignment of the lease to the taxpayer.

**Acquiring Leasehold in Taxpayer's Property.** An existing long-term leasehold interest in the taxpayer's property may be acquired as replacement property. In PLR 9543038 (7/31/95), the IRS relied upon Rev. Rul. 68-394, supra, in concluding that a taxpayer could use the condemnation proceeds from real property to acquire two existing long-term leasehold interests held by the taxpayer's subsidiary corporation in other real property as to which the taxpayer owned the fee. The taxpayer represented that the leasehold interests would be acquired in an arm's length transaction based upon the valuation of an independent appraiser. The IRS applied the like-kind test under Section 1033(g), which applies the same test as Section 1031. (Section 1033 (i) no longer allows taxpayers to acquire replacement property from a related party

following an involuntary conversion).

The holdings in Rev. Rul.68-34 and PLR 9543038 are consistent with the holdings of other rulings in which the IRS has recognized that separate “like-kind” interests may exist with respect to the same parcel of real property. For example, in PLR 7932068 (5/11/79), the IRS held that a taxpayer’s transfer of a fee interest in a portion of land which the taxpayer had leased to a second party in exchange for termination of such leaseholds (which had remaining terms of more than 30 years) qualified as a like-kind exchange. Similarly, Rev. Rul. 76-301, 1976-2 C.B. 241, held that a taxpayer’s exchange of its leasehold interest in an entire building and improvements for cash and an identical sub-leasehold interest in a portion of the building constitutes a like-kind exchange on which the taxpayer may not recognize a loss. In PLR 9620010 (2/13/96), the IRS approved reinvestment of condemnation proceeds from a fee interest in land in replacement land and improvements notwithstanding the taxpayer’s ownership of a lessee’s interest in the replacement property.

**Leasehold Improvements on Taxpayer’s Property.** In one older private ruling letter, the IRS held that a taxpayer could exchange one parcel of real property for a newly created, greater-than-30-year leasehold interest and leasehold improvements on another parcel owned in fee by the taxpayer. PLR 8304022 (10/22/82). The leasehold improvements were constructed by an unrelated contractor who was the lessee under the new lease of the taxpayer’s land and transferee of the taxpayer’s relinquished property. The IRS ruled favorably even though the lease provided for a fixed rent of \$1.00 per year and the taxpayer acknowledged that the contractor

entered into the lease “only for the purpose of facilitating the exchange” and that “the lease terminates if the exchange agreement terminates.” The taxpayer did represent, however, that the contractor “will construct the garage on his own behalf and not as an agent of [the taxpayer].” See also PLR 7823035 (3/9/78) (IRS approved an exchange in which the buyer purchased land from the taxpayer, constructed improvements on the land, and exchanged the improved land for other property owned by the taxpayer).

PLR 8304022 is the only ruling to address an exchange in which the replacement property is a newly created leasehold interest together with leasehold improvements constructed on land owned in fee by the taxpayer. This is not only an older private letter ruling but also there is no analysis of the effect, if any, of the taxpayer’s prior and continuing ownership of the fee interest in the replacement property and the applicability of the step-transaction doctrine to the transaction. For that reason, it is possible that the IRS might reconsider its holding in PLR 8304022 in analyzing a similar transaction today. In particular, the IRS might seek to recharacterize such a transaction as an impermissible exchange of real property for “production services.” See Bloomington Coca-Cola Bottling Company v. Commissioner, T.C.M. 50-608, aff’d, 189 F.2d 14 (7<sup>th</sup> Cir. 1951) and Reg. Section 1.1031(k)-1(e)(4). See also PLR 9243038 (the IRS did not apply the step-transaction doctrine where there was a seven-year period in between the granting of a 90-year ground lease and the subsequent exchange for the leasehold interest and improvements on the land owned by the taxpayer, and there was no binding obligation to make the exchange at the time of the lease). An IRS attack most likely would use the same “step transaction” approach that was recently used successfully in DeCleene v. Commissioner, 115 T.C. No. 34 (2000). See also Smith

v. Commissioner, 537 F.2d 972 (8<sup>th</sup> Cir. 1976). After their purported exchanges, the taxpayers in DeCleene and Smith ultimately ended up with cash and with property that they previously owned, and the application of the step-transaction doctrine to find a taxable sale was not surprising.

If the taxpayer receives a leasehold interest and leasehold improvements as replacement property (and no cash), the transaction may seem less abusive but it is still susceptible to a step-transaction challenge as an exchange of property for construction services following Bloomington Coca-Cola, supra. See also PLR 8921058 (2/27/89), revoking PLR 8847042 (IRS approved exchange of property with contractor for townhouse constructed on land previously owned by the taxpayer). PLR 8921058 revoked PLR 8847042 because the IRS was concerned that the transaction was, in substance, an exchange of property for construction services. Compare Boise Cascade Corp. v. Commissioner, 33 T.C.M. 1443 (1974) (taxpayer's receipt of replacement property which was improved while owned by an unrelated buyer qualified under Section 1031, although property was previously owned by taxpayer's parent company, was sold to the buyer in anticipation of an exchange, was leased back to parent company for 15 years with an option to repurchase it, and parent company supervised construction and was responsible for cost overruns).

In all cases where the replacement property was property previously owned by the taxpayer and improvements are made after either a sale of the property or the granting of a long-term leasehold interest to the accommodator. There will be a substantial risk that the IRS will disqualify the exchange as a transfer of property for construction services under the step-transaction doctrine. Granting a long-term leasehold to the accommodator on taxpayer-owned

property may be less risky than a sale from a legal perspective since the taxpayer retains ownership of the fee. But it presents the same tax risks as a sale.

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### **Disregarded Entities**

In PLR 200118023 (1/31/01), the QI formed a single-member LLC (a disregarded entity) to act as the exchange accommodator. The LLC acquired the replacement property and constructed improvements. The taxpayer received the ownership interest in the LLC to avoid transfer tax that would otherwise be incurred on the conveyance of the improved replacement property by the QI. Using a single-member LLC to avoid transfer tax provides an alternative to using an express agency statement in an agreement with a QI or EAT that holds title to property. See PLR 200148042 (discussed above). If the accommodator forms a single-member LLC to hold title to replacement property, the accommodator can transfer the ownership interest in the LLC, not title to the underlying real estate, to avoid additional transfer tax and complete the exchange with the taxpayer.

Similarly, the IRS held that a post-exchange transfer by the taxpayer (an S corporation) to its wholly-owned, single-member LLC (a disregarded entity) will not violate the holding requirement as applied in Rev. Rul. 75-292, 1975-2 CB 333. PLR 200131014 (5/2/01). The taxpayer exchanged unimproved ranch land for two hotel properties which were “subject to significant and unique liability risks.” The taxpayer engaged in other businesses, including cattle ranching and farming, and desired to separate the liabilities and risks of these businesses. Further, the taxpayer intended to borrow money after the exchange using the hotel properties as collateral.

The prospective lenders required that each of the hotel properties be held in single-asset entities as a condition to make the loans. For these reasons, the taxpayer transferred each replacement property to a separate single-member LLC that will either elect to be disregarded as an entity or rely upon the default classification rule for single-owner entities under Reg. Section 301.7701-3(b)(1)(ii).

The IRS ruled that the post-exchange transfers will not violate the requirement that the replacement properties be “held” for productive use in a trade or business or for investment. Since the hotel properties will be transferred to disregarded entities (the wholly-owned, single-member LLCs), the S corporation will still be considered the direct owner of the properties for federal income tax purposes. The holding requirement as applied in Rev. Rul. 75-292 will not be violated. Rev. Rul. 75-292 provides that an immediate transfer of replacement property by the taxpayer to a corporation invalidates the exchange since the replacement property is acquired for the purpose of transferring it to the corporation and is not “held” by the taxpayer. The IRS also stated that the post-exchange borrowing will occur in a subsequent tax year, and the proceeds will be used exclusively to advance the taxpayer’s business objectives. But these facts are not necessary for a post-exchange borrowing to be treated as a tax-free transaction. Borrowing immediately after an exchange should be permitted, provided that the refinancing is not part of the exchange itself. Compare Behrens v. Commissioner, T.C. Memo 1985-195 (financing was not independent of the exchange and excessive purchase-money loan reduced taxpayer’s equity in the replacement property at the time of the exchange, resulting in the receipt of boot).

PLRs 200118023 and 20013014 are the latest in a series of rulings involving the use of disregarded entities, typically single-member LLCs, in connection with Section 1031 exchanges. See PLR 19991103 (12/18/99), PLR 9850001 (8/31/98), PLR 9807013 (11/13/97), PLR 9751012 (9/15/97). See also 199935065 (5/28/99) (conversion of LLCs to LPs to satisfy lender's requirements did not invalidate exchange since LPs were a continuation of the same tax partnership). These disregarded entities may be used to serve as a QI or an EAT, avoid additional transfer tax, separate liabilities and risks, and satisfy a lender's requirements for a single-asset, bankruptcy-remote entity. If the replacement property will be owned by co-owners, some lenders may allow each co-owner to use a disregarded entity, such as a single-member LLC, to meet their single-asset requirements. The disregarded entities must own the property as tenants in common, however, and a legal or tax partnership cannot be created between them. See Section 1031(a)(2)(D), Rev. Proc. 2002-22 and discussion of UFIs above.

In PLR 200151017 (9/17/01), the IRS determined that a statutory merger of subsidiaries before the QI transferred the replacement property did not disqualify the exchange. The surviving corporation stepped into the shoes of the merged corporation for purposes of receiving the replacement property identified before the merger. Unlike an involuntary conversion under Section 1033, a like-kind exchange is not specified under Section 381(c) as a tax attribute that carries over to a successor corporation following a corporate reorganization. But the IRS stated that Congress did not intend for Section 381(c) to provide an exclusive list of attributes that should be carried over after a reorganization. The IRS concluded that a surviving corporation may receive like-kind property in exchange for property transferred by a predecessor corporation

before a statutory merger (a reorganization under Section 368(a)(1)(A)). This result is consistent with both the continuity-of investment and administrative-convenience rationales of Section 1031 and the principles underlying the carryover of tax attributes following a corporate reorganization. The ruling follows PLR 9850001 (8/31/98) (liquidation and merger of corporations did not disqualify Section 1031 exchange).

### **Like-Kind Property**

A set of recent rulings addressed the like-kind requirement. Some taxpayers that had exchanged real estate for a New York cooperative breathed a little easier when the IRS issued PLR 200137032 (6/15/01). The IRS ruled that the conversion of ownership in a New York cooperative for a condominium interest in the same unit qualified under Section 1031. The interest in the New York cooperative included shares of stock in a residential cooperative corporation and an interest as a tenant in a lease to an apartment unit and common areas with 30 or more years to run. The interest in the cooperative was held to be of like kind to the fee interest for the condominium, although the legal status of stock ownership in a New York cooperative as real property or personal property is unclear. The IRS noted that under various New York statutes, stock ownership in a cooperative is often treated and equated as an interest in real property. Further, the condominium deed constituted a fee interest in the same underlying real property, the same common areas and the same apartment. The only difference is that the taxpayer holds title directly rather than indirectly as a shareholder in a cooperative corporation and proprietary lessee. Under these circumstances, the IRS concluded that directly held title to the apartment through the condominium deed is of like kind to the taxpayer's interest in the same

apartment through the cooperative.

Rev. Rul. 66-40, 1966-1 C.B. 227, found that an interest in a New York cooperative apartment is personal property under New York law, and this ruling has not been expressly overruled. Rev. Rul. 66-40 applied to Section 2515(a) which provided an exception from gift tax for tenancies by the entirety only in “real property.” See also Holmes v. United States, 868 F. Supp. 42 (W.D. N.Y. 1994) (ownership of a New York cooperative is ownership of corporate shares, not real property). But PLR 200137032 cites more recent New York cases and current New York statutes in finding that “stock ownership in a [New York] cooperative is often treated and equated as an interest in real property.” The District Court in Holmes was also reversed by the Second Court on the issue of whether a cooperative is a “dwelling unit” under Section 280A. Holmes v. United States, 96-1 U.S.T.C. Par. 50,299 (2d Cir. 1996) (shares in a cooperative corporation “confer the right to occupy an apartment” and “many other rights typically available only to owners of real property”). PLR 200137032 is consistent with earlier rulings on this issue that applied California law. See PLR 8810034 (12/10/87); PLR 8443054 (7/24/84). See also Rev. Rul. 77-423, 1977-2 C.B. 352 (finding that a condominium unit can properly be characterized as an interest in real property, although state law did not specify whether a condominium unit was real property or personal property).

Three private letter rulings involving the same facts found that a perpetual conservation easement (PCE) granted with respect to the taxpayer’s ranch property was of like kind to a fee interest in a new ranch. PLR 200201007 (10/2/01), PLR 200203033 (10/18/01), and PLR

200203042 (10/18/01). Under the applicable state law, the purpose of a PCE is to retain land predominantly in its natural, scenic, historical, agricultural, forested or open space condition. A PCE is perpetual in duration and constitutes an interest in real property notwithstanding the fact that it is negative in character. The IRS noted that under the regulations, “the types of real estate interests that are within the same kind or class as fee interests in real estate are broad.” For example, a leasehold of a fee with 30 years or more to run may be exchanged for a fee interest. The rulings cited Rev. Rul. 55-749, 1955-2 C.B. 295, and Rev. Rul. 72-549, 1972-2 C.B. 472, which held that perpetual easements in the form of water rights and rights-of-way are of the same kind or class of property to which a fee interest belongs, all being perpetual in nature. Since a portion of the old ranch with respect to which the PCE was granted was used for residential purposes, the IRS stated that the taxpayer must recognize whatever gain is realized as to the residential portion of the old ranch.

PLR 200131014 (5/2/01) involved an exchange of unimproved ranch land for hotel properties. Under Reg. Section 1.1031(a)-1(b), real property is generally considered to be of like kind to all other real property, whether or not the real property is improved. The IRS found that the properties were of like kind to the extent that they were real property. But the acquisition of hotel properties may involve significant amounts of tangible and intangible personal property and such property is not of like kind to real estate. The ruling does not address this issue. See Phillips & Rocca, “Exchanges of Hotels, Restaurants and Other Multiple Properties” (9<sup>th</sup> Annual NRDC Conference 1996). A new ruling under Section 1033 merely cross-referenced Section 1031 for purposes of determining whether replacement property is property of like kind. PLR 200145001

(11/9/01).

The Smalley case (discussed above) involved a like-kind issue. In 1994, the taxpayer transferred 2-year timber cutting rights in his land in exchange for fee interests in three parcels received in 1995. The case was decided under the installment sale rules so that no gain had to be recognized in 1994. The court did not rule on the like-kind issue, but noted that it was “reasonable to believe” that like-kind property would be received since the relinquished and replacement properties were interest in real property. The court’s opinion has a detailed discussion of the authorities on the like-kind issue, including an analysis of Georgia state law as applied to standing timber (and related timber-cutting rights). The opinion notes that not all exchanges of real property interests meet the like-kind requirement. This includes certain interests in land of limited duration or amount, although the interests are characterized as real property under state law (e.g., carved-out oil payments, gravel extraction rights, short-term leasehold interests). See the cases cited in Smalley and Phillips & Rocca, “Like-Kind Real Property” (6<sup>th</sup> Annual NRDC Conference 1993).

### **Conclusion**

This discussion of recent developments has provided an opportunity to see the new in light of the old. These recent developments are part of a vast and growing body of authority, including cases and rulings, applicable to Section 1031 exchanges. Other authorities on what constitutes a tax partnership, agency, and benefits and burdens of ownership, have become increasingly relevant to Section 1031 exchanges. This can be seen in the recent developments concerning UFIs, QIs, EATs, QEAs, and non-safe-harbor reverse exchanges. And this year we added RETICs and LILOs to the alphabet soup. Section 1031 gurus may savor this complexity like

“foodies” dining at a world-class restaurant. But ordinary people like most of our exchange clients get a bad case of indigestion once they learn the details of the recipe. Clients just want a nice finished product. To give them that, each year we, the Section 1031 experts, practitioners and others in the industry, stay on top of recent Section 1031 developments, and we continue to find new ingredients to add to the mix.