

SUMMARY OF RECENT DEVELOPMENTS UNDER SECTION 1031

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Since the last update at the 13th Annual NRDC 1031 Conference (4/27/00), major developments occurred in the area of reverse exchanges. The Service issued Rev. Proc. 2000-37, 2000-40 I.R.B. 308, which provides an administrative safe harbor for certain reverse exchange transactions on or after September 15, 2000. Rev. Proc. 2000-37 will be compared to other recent developments concerning reverse exchanges, including TAM 200039005 (May 31, 2000) (accommodator was taxpayer's agent in merely holding title to replacement property) and DeCleene v. Commissioner, 115 T.C. No. 34 (November 17, 2000) (buyer never acquired benefits and burdens of ownership to replacement property). DeCleene is a special case since the taxpayer previously owned the replacement property (unimproved land). The land was sold to the buyer of the relinquished property and later exchanged after improvements were made. More recently, in PLR 2000111025 (December 8, 2000), the Service blessed a non-safe-harbor reverse exchange using an affiliate (single-member LLC) of an exchange company. The PLR was released on March 16, 2001 and contains an analysis potentially at odds with language in Rev. Proc. 2000-37 and DeCleene. If the PLR is correct, the proper focus in a non-safe-harbor reverse exchange is lack of agency, provided that the accommodator has some, however minimal, benefits and burdens of ownership. We comment on these reverse exchange developments in more detail below.

Compared to all the news on reverse exchanges, most of the other developments would not make front-page headlines. However, there were some interesting releases in the area of undivided fractional interests (UFIs) and qualified intermediaries (QIs). As to UFIs, Rev. Proc. 2000-46, 2000-44 I.R.B. 438, announced that the Service was studying the issue of whether UFIs are interests in an entity (e.g., a tax partnership) and thus excluded from Section 1031. As to QIs, a proposed regulation was published narrowing to definition of a "disqualified person" to allow for a bank member of a control group containing an investment banking or brokerage firm to be a QI. PLR 200027028 was formally released on July 21, 2000. The ruling was discussed last year and addressed an exchange agreement that allowed for an early release of exchange funds when the taxpayer cannot acquire identified property after negotiating in good faith. It generated some controversy and back-to-back articles in the Journal of Taxation by Levine and Weller. The Service also issued an interesting ruling concerning a master exchange program for personal property exchanges. See PLR 2000109022 (November 29, 2000), recently released on March 2, 2001.

Miscellaneous rulings and cases held that: (1) basis received in like-kind exchange reflected pre-conversion personal loss while relinquished property was the taxpayer's residence (Bundren v. Commissioner, T.C. Memo 2001-2); (2) an exchange of a radio license for a television license qualified as a like-kind exchange of intangible personal property (TAM 200035005); (3) co-ownership, pre-exchange refinancing and special allocation of debt respected

by the Service (PLR 200019014); (4) a sale of relinquished property to a related party may trigger Section 1031(f) if related party disposes of relinquished property in 2-year period (FSA 200048021); (5) corporate transferee of replacement property (an option to acquire land) could not step into terminated partnership's shoes under Section 1031 (FSA 1995-12); (6) exchange of outdoor advertising display signs for real property qualifies if an election is made to treat the signs as real property under Section 1033(g)(3) (PLR 200041027); and (7) exchange of U.S. real property for Virgin Islands property qualifies if Section 932 applies to the taxpayer (PLR 200040017).

We now discuss the significant recent developments in more detail. We will analyze them by topic: (i) reverse exchanges, (ii) UFI's, (iii) QI's and (iv) miscellaneous cases and rulings. A copy of the complete text of the cited materials follows this summary. Our commentary assumes some knowledge of the details contained therein and is limited to the important highlights.

Reverse Exchanges

The chronology of the reverse exchange rulings and DeCleene resembles a see-saw but we attempt to balance and reconcile them. First, the Service issued TAM 200039005 (May 31, 2000) but released it on September 29, 2000 after the issuance of Rev. Proc. 2000-37. In the TAM, the taxpayer intended to engage in a deferred exchange but the sale of the relinquished property fell through and the seller of the replacement property demanded an immediate closing. Accordingly, the taxpayer closed on the replacement property but placed title in the accommodator's name before disposing of the relinquished property. Subsequently, the taxpayer contracted to sell the relinquished property and entered into an exchange agreement with the accommodator. The accommodator closed the relinquished property and later transferred the replacement property to the taxpayer. The TAM holds that the transaction was a separate purchase followed by a taxable sale and not an exchange.

The Service noted that the safe harbors of Reg. Section 1.1031(k)-1(g), including the one for a qualified intermediary, do not apply to a reverse exchange. The Service cited the Preamble to T.D. 8346, 1991-C.B. 150. On the facts presented, the Service found that the accommodator merely acted as the taxpayer's agent or nominee in holding title to the replacement property. The taxpayer negotiated the purchase, provided the funds, was personally liable on the purchase money mortgage while the accommodator was not, and ordered that the replacement property be titled in the accommodator's name. Moreover, a written exchange agreement did not exist at the time the accommodator acquired title to the replacement property. Thus, the accommodator did not acquire the replacement property, as required by a written agreement with the taxpayer, in accordance with Reg. Section 1.1031(k)-1(g)(4)(iii)(B). The accommodator could not have been a QI even if the safe harbor applied to a reverse exchange.

The Service also noted that the transaction lacked the necessary reciprocity and interdependence for an exchange. The taxpayer could have terminated the "exchange" transaction after the purchase of the replacement property and could have kept the relinquished

property if the taxpayer had found no satisfactory buyer. Accordingly, the purchase and subsequent sale were treated as separate “noninterdependent” transactions. Exchange treatment was disallowed following a line of other failed reverse exchange cases. See, e.g., Bezdjian v. Commissioner, 845 F.2d 217 (9th Cir. 1988), aff’g T.C. Memo 1987-140; Lee v. Commissioner, T.C. Memo 1986-294; Dibsy v. Commissioner, T.C. Memo 1995-477; Lincoln v. Commissioner, T.C. Memo 1998-421. In each of these failed reverse exchange cases, the taxpayers merely purchased one property and subsequently sold another property to a different party. The complete lack of contractual interdependence between each property purchase and sale foreclosed any argument for exchange treatment, regardless of whether the purported exchange would be a reverse, simultaneous or deferred exchange. In these situations, the taxpayers’ steps were not an interrelated exchange transaction.

A written exchange agreement with the accommodator at the time of the acquisition of the replacement property could have avoided the lack of reciprocity and interdependence. The TAM cited and distinguished Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968) in which the sales price of the old equipment was dependent upon the purchase of new equipment. A Section 1031 exchange was deemed to occur even though the sale and purchase were accomplished by separately executed contracts. The Service stated that “the facts of this case do not show such interdependence.”

The TAM was issued on May 31, 2000 but released on September 29, 2000 after Rev. Proc. 2000-37 was released. With the release of both the Rev. Proc. and the TAM in September 2000, the Service signaled that not all parking arrangements give rise to an agency agreement, only those of the type specified in the TAM. The taxpayer and accommodator in the TAM could have complied with the requirements of Rev. Proc. 2000-37 if (i) they had entered into a written exchange agreement (they could have done so within five business days after the accommodator acquired title to the replacement property and satisfy the provisions specified in Section 4.02(3) of the Rev. Proc.); and (ii) the relinquished property was sold to the buyer within 180 days after the acquisition of the replacement property. All of the other requirements for a qualified exchange accommodation arrangement (QEAA) under Section 4 of the Rev. Proc. appeared to have been met, including the holding of legal title (“qualified indicia of ownership”) by the accommodator (who was not a “disqualified person”).

Rev. Proc. 2000-37 was the focus of a special session in December 2000 and January 2001 and will be analyzed separately in this year’s program. But when discussing recent Section 1031 developments, it is hard to ignore it. The Rev. Proc. is front-page headline news for the exchange community. We make the following observations:

1. The Rev. Proc. is simply a statement of the Service’s procedures. It is not a regulation with the force and effect of law. If the terms of the Rev. Proc. are met, the Service will not challenge (a) the qualification of the property as “replacement property” or “relinquished property” under Section 1031 or (b) the treatment of the exchange accommodation titleholder (EAT) as the beneficial owner of such property for federal income tax purposes. While the Service will not disallow on audit an exchange that falls within this administrative safe harbor,

the Rev. Proc. and the statements made therein have no precedential authority and are not binding on any court.

2. The Rev. Proc. states that, as a general rule, the party that bears the economic burdens and benefits of ownership is considered the owner of property for federal income tax purposes, citing Rev. Rul. 82-144, 1982-2 C.B. 34. But the Rev. Proc. itself eschews a “benefits and burdens” analysis for parking arrangements that meet the requirements for a QEAA (Section 4.02). The Rev. Proc. explicitly allows agreements and other arrangements, including guarantees, indemnification, loans, leases, management agreements, put and call options, and the shifting of gain or loss, even though the agreements contain terms that might not otherwise result from arm’s length bargaining between unrelated parties (Section 4.03).

3. The reference to a “benefits and burdens” test in general and Rev. Rul. 82-144 in particular has caused concern for non-safe-harbor reverse exchanges, such as build-to-suit exchanges that cannot be completed in 180 days. Rev. Rul. 82-144 held that a taxpayer was the owner of tax-exempt obligations notwithstanding the fact that the taxpayer shifted the risk of loss of the obligations through the simultaneous purchase of a “put.” The ruling notes that two significant factors of ownership are: (1) which party has the right to dispose of the property and (2) which party bears the risk of profit or loss with respect to the property.

The taxpayer in the ruling met both tests and was entitled to the full benefit of any appreciation in the value of the obligations. The ruling distinguished situations in which the taxpayer was holding obligations as security on a loan or for the benefit of another party (including cases where the other party had rights to purchase or reacquire the property at a fixed price). See, e.g., Rev. Rul. 74-27, 1974-1 C.B. 24; Union Planters National Bank of Memphis v. United States, 426 F.2d 115 (6th Cir. 1970), cert. denied 400 U.S. 827 (1970). The ruling also noted that, while the “puts” limited the taxpayer’s risk of loss, an arm’s length price was paid for the “puts”, their primary purpose was to increase liquidity for the taxpayer’s portfolio rather than to shift risk of loss, and the “puts” had a short, fixed duration that was substantially less than the life of the obligations.

Query should this line of cases and rulings apply to a typical non-safe-harbor reverse exchange? How relevant are these authorities to parking arrangements under Section 1031? The Rev. Proc. cites Rev. Rul. 82-144 while PLR 2000111025 ignores it.

4. The Rev. Proc. favors parking arrangements by providing a safe harbor for transactions completed in a 180-day period. It does not address a “true” reverse exchange. See Rutherford v. Commissioner, T.C. Memo 1978-505 (exchange of heifers); PLRs 9823045 and 9814019 (exchange of power line easements). The Rev. Proc. recognizes reverse exchanges using both the “exchange first” and “exchange last” methods and provides a special “reverse identification” rule for the “exchange last” method. Within 45 days after the EAT acquires the replacement property, the relinquished property must be identified consistent with Reg. Section 1.1031(k)-1(c), including the identification of alternative and multiple properties.

5. The Rev. Proc. acknowledges that taxpayers have engaged in parking transactions to facilitate reverse exchanges and that they attempt to structure the transaction so that the accommodation party has “enough of the benefits and burdens” relating to the property to be treated as the owner for federal income tax purposes. The Rev. Proc. explicitly states: “Further, the Service recognizes that ‘parking’ transactions can be accomplished outside of the safe harbor provided in this revenue procedure.” PLR 2000111025 confirms this “recognition” by approving a parking arrangement in which the accommodator had minimal, but apparently “enough”, of the benefits and burdens of ownership. The key to the PLR was not benefits and burdens of ownership, but rather the taxpayer’s intent to exchange, the structure of the transaction as an integrated exchange, and the fact that the accommodator was not the taxpayer’s agent.

6. The principles set forth in the Rev. Proc. have no application to any federal income tax determinations other than the particular issues presented under Section 1031 and determinations that involve a QEAA. For example, the Service may recast amounts paid as a fee to an EAT to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in the Rev. Proc. include the treatment of payments that shift gain or loss after the relinquished property is sold, and whether an EAT may be precluded from claiming depreciation deductions (e.g., as a dealer).

7. The EAT cannot be the taxpayer or a disqualified person under Reg. Section 1.1031(k)-1(k). An EAT may be an affiliate or division of a QI since services as a EAT are disregarded in determining status as a QI. See PLR 2000111025 (accommodator was a single-member LLC, treated as a division of an exchange company for federal income tax purposes). The EAT must be subject to federal income tax. Thus, the safe harbor cannot be used as a means to generate tax-exempt income or similar tax benefits.

8. The Rev. Proc. spells out what must be contained in a QEAA agreement:

- a. The EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and the Rev. Proc. (Does this language suggest that the EAT may act expressly as the taxpayer’s agent?)
- b. The taxpayer and EAT agree to report the acquisition, holding and disposition of the property as provided in the Rev. Proc.
- c. The agreement must specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes. (Among other things, this implies that only the EAT, and not the taxpayer, may be able to claim depreciation deductions with respect to the property. See our separate article, “Tax Reporting of Reverse Exchanges,” in this year’s program.)

d. 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.

9. A well-drafted QEAA agreement will contain other things:

a. A statement of the taxpayer's bona fide intent that the property held by the EAT represents either replacement or relinquished property in an exchange intended to qualify under Section 1031. Also provisions for an integrated and contractually interdependent exchange between the taxpayer and the EAT or the taxpayer and a QI. If the exchange is between the taxpayer and a QI, the EAT will simply be seller of the replacement property under the "exchange last" method or the buyer and future seller of the relinquished property under the "exchange first" method.

b. Provisions concerning the financing of the property, including any down payment by the EAT, any loan by the taxpayer or a related party, and third-party financing issues (the terms of the note, the deed of trust, any requirements for a special purpose bankruptcy-remote entity, any environmental or other indemnities, any guarantee by the taxpayer or a related party). The parties must also consider the impact of a transfer of the relinquished property to an EAT under the "exchange first" method, including triggering due-on-transfer provisions in the existing financing.

c. Title insurance issues, including review and approval of a preliminary title report, the title policy and endorsements, and arranging for a binder or discount on the subsequent transfer of the property.

d. Provisions concerning the interim operation of the property, including the leasing, management and improvements, including selection of construction contractors and the supervision, approval and financing of construction.

e. A representation and warranty of the EAT, guaranteed by a parent company or other responsible person, that the ownership, management and structure of the EAT will be maintained; the property will be operated by the EAT in a prudent and commercially reasonable manner; no new liens or encumbrances of the EAT will attach to the property except as otherwise agreed by the parties; title will be transferred to the taxpayer ("exchange

last”) or the buyer (“exchange first”) subject only to the agreed liens and exceptions; the EAT will transfer the property as provided in the agreement and not otherwise dispose of it; and the EAT will disburse the consideration received from the transfer of the property in accordance with the agreement, including payment of closing costs, EAT fees or other income, return of any down payment of the EAT, repayment of any loans made by the taxpayer or a related person (including interest thereon), and payment of all third-party financing (including interest thereon).

f. Under the “exchange first” method, provisions for the sale or other disposition of the relinquished property by the EAT, including listing agreements, approval of terms of sale, real estate transfer disclosures, representations and warranties of the seller, and appropriate indemnifications. Also provisions for any variations in the value of the relinquished property from the estimated value on the date of the EAT’s acquisition, including future payments to or from the taxpayer on account of such variations and the treatment of such payments.

g. Provisions for insurance, including the amount and type of insurance, identity of insureds, and payment of the premiums. Insurance may also be addressed under a net lease of the property to the taxpayer.

h. Provisions for real estate and other taxes, including property tax reassessment upon the transfer of the relinquished property to the EAT under the “exchange first” method. A supplemental assessment may not be made until after the EAT sells the relinquished property. The supplemental assessment may then become an unsecured debt of the EAT. The EAT will want to pass that cost to the taxpayer under a net lease or other provision of the agreement. The parties will also want to consider sales tax on any personal property and gross receipt taxes and other taxes and fees imposed upon the EAT, including EATs that are LLCs.

i. Provisions for environmental studies, representations, warranties and indemnities concerning the property.

j. Provisions for tax and other indemnifications, releases and guarantees, including costs of defense and reasonable attorney’s fees.

k. Provisions for an exit strategy, including puts and calls, the consideration to be paid for the option, the strike price (fair market value or fixed or formula amount), the effect of a party not exercising an option, and any required post-sale payments (e.g., if the EAT would otherwise incur a loss of sale). The Rev. Proc. allows puts and calls at fixed or formula prices, “effective” for a period not in excess of 185 days from the date the property is acquired by the EAT. This appears to mean that the property must actually be transferred pursuant to the exercise of the put or call in order to be a permissible arrangement under the Rev. Proc.

l. Provisions that spell out the EAT’s fees or other income, including set-up and entity fees, lease income, sale profit, construction fees, financing fees, option fees, etc. Also provisions that require reimbursement for the EAT’s out-of-pocket costs.

m. Provisions that address the ownership, management and structure of the EAT, assignment rights, and potential savings on title insurance and transfer tax.

n. Provisions that evidence an intent to comply with the 180-day time limitation of the safe harbor. The effect of the transaction and actions to be taken if the property is not transferred in the 180-day period. Do the parties proceed with a non-safe-harbor exchange or is the transaction terminated? If the transaction is terminated, how do the parties account for and report the transaction? Does this depend on whether or not the EAT is the taxpayer’s agent?

o. Unlike the deferred exchange regulations, the Rev. Proc. does not say whether or not the EAT may act expressly as the taxpayer’s agent. But there is nothing in the Rev. Proc. to indicate that the EAT would be disqualified if it was the taxpayer’s agent under state law. In fact, the QEAA agreement must provide that the EAT is “holding the property for the benefit of the taxpayer” in order to facilitate a Section 1031 exchange. Section 4.04 of the Rev. Proc. also provides that property will not fail to be treated as held in a QEAA merely because the accounting, regulatory or *state*, local or foreign tax *treatment* of the arrangement is different than the Rev. Proc. If the EAT is the taxpayer’s agent under state law but the parties nevertheless comply with all of the provisions of the Rev. Proc. (including treatment of the EAT as the beneficial owner for all federal income tax purposes and consistent tax reporting), the Service should not challenge the exchange. The spirit of the Rev. Proc. is that an EAT under the safe harbor should

be treated in the same way as a QI under the deferred exchange regulations.

p. If the EAT is the taxpayer's agent, the EAT would receive the legal protections of its principal, additional transfer tax may be avoided on the transfer of the property, and tax treatment of a transaction that terminates because it is not completed in the 180-day period would be more certain. However, if the EAT is the taxpayer's agent, the exchange may not qualify for *state tax* purposes. The Rev. Proc. is only a statement of the Service's procedures for federal income tax purposes.

q. The 180-day time limit of the safe harbor may encourage a market niche for "white knights" to purchase the relinquished property and allow the transaction to close in time. No later than 180 days after the transfer of property to the EAT: (i) the property must be transferred (either directly or indirectly through a QI) to the taxpayer as replacement property ("exchange last" method), or (ii) the property must be transferred to a person who is not the taxpayer or disqualified person as relinquished property ("exchange first" method). Further, the combined time period that the replacement and relinquished properties are held in a QEAA cannot exceed 180 days. The 180-day time period appears to be fixed in the same way as for a deferred exchange under Section 1031(a)(3). The Rev. Proc. states that it only applies when the exchange is accomplished "within a short time" after the property is transferred to the EAT.

r. Interestingly, under the "exchange last" method, it is sufficient if the EAT transfers the replacement property to the taxpayer in the 180-day period. There is no express prohibition on the transfer of the relinquished property to a related party or other disqualified person (assuming the person is not in fact the taxpayer's agent) in order to complete such an exchange. The transfer of the relinquished property to a related party or other disqualified person would have to be respected under general tax principles since it would not be protected by the safe harbor for a QEAA (the "combined time period" may not exceed 180 days). Under the "exchange first" method, however, the EAT cannot transfer the relinquished property to the taxpayer or a disqualified person, including a related party, in order to qualify under the safe harbor.

s. The Rev. Proc. is effective only for QEAs entered into with an EAT who acquires the property on or after September 15, 2000.

No inference is intended with respect to similar arrangements entered into prior to the effective date of the Rev. Proc. But how can an IRS agent practically ignore the Rev. Proc. when auditing a similar prior arrangement? What is good now (in fact, what is a “safe harbor” now) must have been good then, right? As Cuff puts it, the Rev. Proc. is like a big pink elephant wearing a pink dress and pink dancing shoes. It really is hard to ignore.

In DeCleene, the Tax Court applied a “benefits and burdens” test to a parking transaction with the intended buyer of the relinquished property. See also Section 2.03 of Rev. Proc. 2000-37 which indicates that a “benefits and burdens” test applies as a general rule to determine ownership for federal income tax purposes. But the court applied this test in a very special case. In DeCleene, the replacement property was previously owned by the taxpayer and purportedly sold to the buyer three months prior to the exchange. The essential facts of DeCleene are as follows:

1. The taxpayer (T) purchase unimproved property in 1992 and the acquisition was not part of an integrated plan to effect an exchange.
2. In September 1993, a buyer (B) wished to acquire T’s relinquished property (a property on which T operated his business since 1977). B agreed instead, at T’s request, to acquire the unimproved property (“replacement property”), subject to a reacquisition agreement.
3. The parties agreed that the properties were of equal value (\$142,400) and T quitclaimed title to the replacement property to B for a deferred cash consideration of \$142,400 to be paid at a second closing. No interest accrued on the deferred cash consideration.
4. B agreed to build a building on the replacement property to T’s specifications. B also agreed to reconvey the property to T, with the substantially completed building on it, in exchange for the relinquished property that B wanted to buy. The transactions closed as agreed in December 1993.
5. While B held title to the replacement property, T retained beneficial ownership thereof. B had no equity interest in the replacement property and made no economic outlay to acquire it. T was responsible for all transaction and closing costs, including accrued property taxes. B paid no amounts and was not obligated to pay any amounts with respect to the replacement property, including the improvements constructed thereon, until it received the relinquished property and paid the \$142,400 to T.
6. Construction was financed by a note and mortgage guaranteed by T that were nonrecourse as to B. No interest accrued or was paid on the nonrecourse note. T assumed personal liability for the note at the second closing. Through his guaranty and reacquisition obligation, T was at all times at risk with respect to the replacement property.

7. B had no potential for any economic gain or loss on its acquisition and disposition of title to the replacement property. The reacquisition agreement did not take into account any value added to the replacement property by reason of the building constructed on it in the interim.

8. T did not use a third party facilitator to acquire the replacement property either in 1992 (when the land was acquired, which was a year or more before T was ready to transfer the relinquished property and relocate his business to the replacement property) or in 1993 when the property was transferred to B, subject to the reacquisition agreement.

On these special facts, the court held that T remained the beneficial owner of the replacement property during the 3-month period that B held bare legal title and the building was constructed. Thus, no tax significance attached to the “transfer” of title to B in September 1993. Since T remained the beneficial owner of the replacement property for income tax purposes, the \$142,400 payment received by T was deemed to be the sales price for the relinquished property. The court noted that “a taxpayer cannot engage in an exchange with himself; an exchange ordinarily requires a ‘reciprocal transfer of property, as distinguished from a transfer of property for a money consideration.’” (Citing Reg. Section 1.1002-1(d).)

DeCleene reminds one of Chase v. Commissioner, 92 T.C. 874 (1989). The taxpayers in both cases did so many things wrong that it is hard to determine which particular facts were fatal. The taxpayer cited a series of favorable cases, including J.H. Baird Publ. Co. v. Commissioner, 39 T.C. 608 (1962); Coupe v. Commissioner, 52 T.C.394, 409-410 (1969); 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975); Biggs v. Commissioner, 69 T.C. 905 (1978), affd. 632 F.2d 1171 (5th Cir. 1980); and Fredericks v. Commissioner, T.C. Memo. 1994-27. The court viewed none of these cases as a “reverse exchange,” including Biggs. Biggs clearly included a “parking” transaction but a third-party facilitator was used and the replacement property was not previously owned by the taxpayer.

The court found all of these cases to be “highly fact specific and therefore distinguishable.” Moreover, the court stated: “Petitioners have read these cases selectively, emphasizing in each of them what the taxpayer got away with. In so doing, petitioners have lost sight of the cumulative adverse effect on their position of all the facts in the case at hand, which have led to our conclusion that WLC [B] never acquired beneficial ownership of the Lawrence Drive [replacement] property. It would therefore be a sterile exercise to engage in a detailed recitation of the facts of these cases and a point-by-point refutation of their applicability to the case at hand.” [Emphasis added.]

The court also analogized the facts to Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951). After finding that B had no (zero) benefits and burdens of ownership with respect to the replacement property (other than bare legal title), the court was left with the same situation as Bloomington Coca-Cola Bottling Co. A building was built for T on land that T owned and T was obligated to pay for the building. T simply sold the

relinquished property to the same party with whom T dealt in connection with the building of the new facility.

The significance of the improvements in DeCleene is unclear. T's relinquished property apparently was worth \$142,400 and the replacement property was valued at the same amount for purposes of the transaction. If the replacement property really was worth \$142,400, T would not need to take into account the value of the improvements to trade even or up in value on the exchange. In fact, the improvements were ignored by the parties in the second closing. But without the improvements and the 3-month period during which B held title, the transaction would be stripped to its essential facts. If T sold the replacement property to B and the exchange occurred a day later, for example, the court would have had no trouble finding that Section 1031 did not apply under the step-transaction doctrine and existing Section 1031 authorities. See, e.g., Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976), affg. T.C. Memo 1975-153; Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971). Footnote 9 of the court's opinion recognized this point and noted that the "subject transactions satisfy the most restrictive and rigorous version of the step-transaction doctrine: the binding commitment test."

DeCleene could have simply ended there. Nothing more needed to be said. But the opinion contains other language, such as (i) the transaction "amounted to nothing more than a parking transaction," (ii) the reference to "risks of ownership" that the accommodating parties had in PLR 7823035 (March 9, 1978) and PLR 9149018 (September 4, 1991), and (iii) footnote 7 which cites Rev. Rul. 82-144 and related cases and is quoted below.¹

Thus, the court in DeCleene cites the same potentially disturbing line of cases and rulings as Section 2.03 of Rev. Proc. 2000-37. Many non-safe-harbor reverse exchanges could be regarded as mere "parking transactions" with little or no economic substance and disallowed under a "benefits and burdens" test following these authorities. We submit, however, that the application of such a "benefits and burdens" test under Section 1031 was previously unprecedented. At least this remains the case with third-party facilitators where the taxpayer intends to exchange and there is a mutually integrated plan to exchange at the outset of the transaction. See, e.g., Biggs, supra. The test was and has always been agency under Section 1031, not a requisite amount of "benefits and burdens."

Importation of these alien authorities (which apply a "benefits and burdens" test to resolve entirely different tax issues) flies in the face of one of the earliest cases under Section

¹In footnote 7, the court stated: "We have found no other like-kind exchange cases in the Seventh Circuit that bear on the issue in the case at hand. However, another Seventh Circuit case worth noting is Patton v. Jonas, 249 F.2d 375 (7th Cir. 1957), which applies the same analysis as the line of Sixth Circuit cases culminating in First Am. Natl. Bank of Nashville v. United States, 467 F.2d 1098 (6th Cir. 1972), which hold that "repo" transactions in tax-exempt bonds are to be treated as secured loans so that the purchaser in form is treated as a lender not entitled to exclude the tax-exempt bond interest from its income; this is because the original seller remains the owner of the bonds for tax purposes. See also Green v. Commissioner, 367 F.2d 823, 825 (7th Cir. 1966), affg. T.C. Memo. 1965-272; Commercial Capital Corp. v. Commissioner, T.C. Memo. 1968-186. Compare Rev. Rul. 74-27, 1974-1 C.B. 24 (repurchase obligation) with Rev. Rul. 82-144, 1982-2 C.B. 34 (separately purchased and paid-for put)."

1031. See Mercantile Trust Company v. Commissioner, 32 B.T.A. 82 (1935) (title company facilitated 4-party simultaneous exchange and was not taxpayer's agent). The court made it clear that an intermediary need not have the benefits and burdens of ownership before exchanging property but may acquire title solely for the purpose of the exchange. See also Barker v. Commissioner, 74 T.C. 555 (1980) (a party can have transitory ownership of exchange property solely for purposes of effecting the exchange); Biggs, *supra*.

Fortunately, PLR 200111025, the last recent development with respect to reverse exchanges, applies the correct test under Section 1031, in our opinion. The PLR deals with a non-safe-harbor reverse exchange. While Section 6110(k)(3) provides that it may not be used or cited as precedent, the PLR is well-reasoned and written like a court opinion. It applies the existing authorities under Section 1031 and does not muddy the waters with foreign authorities (such as Rev. Rul. 82-144 which applies a "benefits and burdens" test in a totally different context than Section 1031).

In PLR 200111025, the taxpayer (T) owned relinquished property (the Park) and granted an option to a conservation organization (B) to acquire the property for public parkland. The exercise of the option and consummation of the purchase was subject to a variety of conditions, including public hearings, procedural steps and public agency approvals. T apparently located its desired replacement property in the interim and arranged for it to be parked with an accommodating party (A). A is a single-member LLC which is treated for federal income tax purposes as a division of an exchange company (E). Neither A nor E are disqualified persons under Reg. Section 1.1031(k)-1(k).

A acquired the replacement property (Property) and paid the related transaction costs by borrowing from a bank and additional funds from T pursuant to a full recourse line of credit. The bank loan was signed by A, secured by the Property, bore interest and had a fixed maturity date, subject to an optional 3-month extension. T signed a payment guaranty and environmental indemnification in favor of the bank. A agreed to pay T a loan guaranty fee. T's loan to A was unsecured, bore interest and was due on the earlier of the sale of the Property or a fixed maturity date. Apparently, A put none of its own funds into the acquisition of the Property.

A leased the Property to T under a standard "triple net" lease, providing for monthly base rent plus additional rent equal to all taxes, insurance and maintenance costs with respect to the Property. The lease had an initial one-year term with an optional one-year extension of the term. The amount of rent exceeded all costs of operating the Property, including debt service. A also assigned its interest in certain leases and contracts to T. As long as A owns the Property, A and T agreed to report the transactions for federal income tax purposes in accordance with their form, with A as the owner and master lessor and T as the master lessee and as the lessor under the subleases.

A and T also entered into a Real Estate Acquisition Agreement (Agreement) pursuant to which A entered into the lease with T, the acquisition agreement with the seller of the Property, the bank loan and T's loan. Under the Agreement, T has an option to purchase (or acquire

through a tax-deferred exchange) all or a portion of the Property for an amount equal to its fair market value. For this purpose, the fair market value is deemed to be equal to A's cost of acquiring the Property for any purchase by T within 18 months of A's acquisition. If the option is terminated, upon the occurrence of certain events, A may sell the Property in accordance with certain procedures set forth in the Agreement.

If A does not do so, it has the potential for exposure to economic loss. However, A is not obligated to sell the Property and may retain the Property and thus has the potential to realize economic gain. If A elects to sell the Property, T must reimburse A for a certain portion of the net sales proceeds as compared to all of A's costs. If the net proceeds exceed such costs, A may retain the excess. If the Property cannot be sold despite A's good faith efforts, the net sales proceeds are deemed to be a certain amount and T must also reimburse A for costs incurred.

The Agreement includes a general environmental release and indemnification of A and its affiliates and a tax-deferred exchange provision stating T's right to effect an exchange for all or a portion of the Property. A agreed to cooperate with T with respect to any such exchange. T also had the right to assign its rights and responsibilities under the Agreement to a QI.

Since the inception of the transaction, T intended to exchange the Park for all or a portion of the Property under Section 1031. As soon as B exercises its option and is in a position to acquire the Park, T will assign its rights and transfer the Park to a QI. The QI will then sell the Park to B and receive the sales proceeds. Within 45 days after the transfer of the Park by T to QI, T will identify all or a portion of the Property as replacement property. QI will acquire the Property from A pursuant to an assignment of T's rights under the Agreement and transfer the acquired Property to T within the time limit of Section 1031(a)(3).

The PLR contains a detailed discussion of the relevant Section 1031 authorities. Rev. Proc. 2000-37 did not apply because A's acquisition predated the effective date. Even if the acquisition had occurred on or after the effective date, the ruling notes that A's acquisition of the Property will be more than 180 days after the transfer of the Property to T. Accordingly, the ruling squarely addressed a non-safe-harbor parking transaction.

The PLR first cited the plethora of cases under Section 1031 permitting taxpayers "significant latitude" in structuring tax-deferred exchanges. The ruling noted that case law authority exists for a true reverse exchange, citing Rutherford. The ruling then analyzed the facts and holdings of Biggs and Baird in detail. It concluded that "an agency analysis, therefore, underlies the determination of whether or not an exchange occurred." From these cases (Biggs, in particular) and the Supreme Court decisions regarding agency, the ruling divined the test under Section 1031 for determining a valid exchange.

Failed reverse exchanges, such as Bezdjian were distinguished on the ground that the taxpayers' steps were not an interrelated exchange transaction. DeCleene was also distinguished on the ground that an integrated plan to exchange did not exist at the time the replacement property was acquired by the taxpayer in 1992. The ruling states: "As a result, the court did not

reach the issue of the circumstances under which a parking transaction that is entered into as part of a plan to accomplish a like-kind exchange qualifies for nonrecognition under section 1031.” As noted above, DeCleene could have been distinguished simply as a step-transaction case like Smith, supra, which also involved property that the taxpayer previously owned.

To flesh out the agency test under Section 1031, the PLR noted and applied the Supreme Court’s agency analysis as set forth in Commissioner v. Bollinger, 485 U.S. 340 (1988) and National Carbide Corp. v. Commissioner, 336 U.S. 442 (1949). This agency analysis has four factors and two requirements, “the sum of which has become known as the ‘six National Carbide factors.’” Bollinger, 485 U.S. at 346. These factors are as follows:

- (1) Whether the party in question operates in the name and for the account of the principal;
- (2) binds the principal by its actions;
- (3) transmits money received to the principal; and
- (4) whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal.
- (5) The agency-principal relationship cannot be founded solely on the fact that the principal owns the agent. For example, a corporation will in most cases be treated as a taxable entity separate from its sole stockholder.
- (6) The business purpose of the party in question must be the carrying on of the normal duties of an agent.

The PLR concluded its thorough discussion and analysis of the law by setting forth the applicable test under Section 1031. The ruling states: “The foregoing authorities present three general requirements for an exchange to be recognized as a like-kind exchange under Section 1031 in similar situations:

- (1) the taxpayer must demonstrate its intent to achieve an exchange and the properties to be exchanged must be of like kind and for a qualified use [“intent to exchange”];
- (2) the steps in the various transfers must be part of an integrated plan to exchange the relinquished property for the replacement property [“integrated plan”]; and
- (3) the party holding the replacement property must not be the taxpayer’s agent [“no agency”].”

On the facts of the ruling, this test was met. First, T demonstrated a clear and consistent intent to exchange the Park for the Property from the inception of the transaction. Second, all of the steps in the transactions, including the various transfers and agreements, were interdependent and integrated parts of a single overall plan to achieve an exchange by T. Finally, the PLR applied the six National Carbide factors. The ruling noted that, under the Section 1031 case law, merely facilitating an exchange is not tantamount to being the taxpayer's agent (see Biggs, Baird, Fredericks, supra). Based on these authorities, the PLR concluded that A was not T's agent.

The first two requirements (intent to exchange and integrated plan) are likely to be met in any proper parking transaction. The focus will then be on the third requirement: no agency. Thus, we refer to this test under Section 1031 as the "agency test." In finding no agency relationship between A and T, the PLR discussed these key facts: (1) A conducted all business, held title and entered into all agreements in its own name and for its own account and was never referred to as T's agent; (2) T did not contractually authorize A to bind T by A's actions; (3) A did not simply transmit money that A received for its account to T; (4) the receipt of income by A was not attributable to the services or assets of T but rather the receipt of income by each party was based on lessor-lessee relationships; (5) A and T were separate legal entities, neither A nor E were owned by or related to T, and E (as the sole member of A) will report A's rental income and expenses on its tax returns; and (6) A's business purpose is not to carry on the normal duties of an agent.

Except for situations in which the accommodating party acts expressly as the taxpayer's agent in a safe harbor exchange under Rev. Proc. 2000-37, this agency test should be satisfied in most non-safe-harbor parking transactions. The role of the accommodating party will be to facilitate an exchange on its own and for its own account, and not to act as the taxpayer's agent. If the legal analysis contained in the PLR is correct, non-safe-harbor parking transactions should be successful, provided that all of the proper formalities are observed (written agreements, leases, notes, actions consistent therewith, tax reporting and no express indications of an agency relationship). This will be the case even though the accommodating party has minimal benefits and burdens of ownership.

But is the PLR correct? We discussed this precise issue with the author of the PLR in October 2000. Section 2.03 of Rev. Proc. 2000-37 indicated that a "benefits and burdens" test would be applied to a non-safe-harbor reverse exchange. We objected to such a test based on the existing Section 1031 authorities, including Biggs and Baird, which applied a different test under Section 1031, namely, the agency test. Accordingly, we believe that the legal analysis contained in the PLR is correct. But, again we caution, it is not precedent and may not be used or cited as such.

Moreover, the facts of the PLR indicate that A, the accommodating titleholder to the replacement property, had some benefits and burdens of ownership, however small or remote. A apparently did not put any of its own funds into the acquisition of the replacement property and had no equity investment. See DeCleene. But the financing was stated to be "pursuant to a full

recourse line of credit.” If A (a limited liability company) had no major assets, however, the full recourse nature of the financing would have much more significance to T as guarantor than to A as signer of the loan. A also received rental income under the master lease in excess of all costs and debt service (arguably a benefit of ownership of the fee). If T did not exercise its option to purchase or exchange into the Property, A was not obligated to sell and could retain the Property. Thus, A had potential exposure to gain or loss if it did not elect to sell the Property in accordance with the termination sale procedures set forth in the Agreement. Any risk of loss of A is unclear except in the case that it did not elect to sell the Property. The reimbursement provisions of the Agreement likely protected A against any loss and may have guaranteed a profit if A could not sell the Property despite its good faith efforts to do so.

Accordingly, the facts of the PLR may be distinguished from DeCleene where the court held that the accommodating buyer had no (zero) benefits and burdens of ownership with respect to the replacement property. Taxpayers proceeding with non-safe-harbor parking transactions would be wise to have some benefits and burdens of ownership vested in the accommodating titleholder. While taxpayers may still rely on Biggs, Baird and the agency test, those cases involved relatively short periods of ownership by the accommodating party (e.g., a few months, not a year or more). Compare DeCleene (title held for only 3 months). The courts might find a long-term parking transaction too abusive, irrespective of prior Section 1031 cases. The courts might apply a “benefits and burdens” test and traditional substance-over-form principles to such cases where the accommodating party simply holds bare title, earns a fee and has no benefits and burdens of ownership whatsoever.

Undivided Fractional Interests (UFIs)

Rev. Proc. 2000-46, 2000-44 I.R.B. 438 was issued concerning UFIs in real property. The Service indicated that it was studying these arrangements. The Rev. Proc. was issued in response to private letter ruling requests. These requests were made to the Service to approve exchanges of UFIs, also known as tenancy-in-common interests, in net leased real property. The Service recently added UFIs to a length list of projects that it plans to give guidance on in the future.

In such arrangements, the exchangers may master lease the replacement property to the promoter or an affiliate on a triple net basis for a significant term. The arrangements vary but promoters or their affiliates are involved, and they lease or manage the property and earn more than just a real estate commission on the deal. Typical terms of such arrangements 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 exchangers 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 exchangers. The master lessee may pay any principal and interest payments to an exchanger’s lender upon request, with the net amount to the exchanger. 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 UFIs may or may not be subject to contractual restrictions, such as waiver of the right to partition, rights of first refusal and options.

Those making the ruling requests have contended that UFIs in net leased real property are not interests in separate entities (i.e., partnerships or corporations) for federal income tax purposes and, thus, that UFIs qualify as exchange property. Rev. Proc. 2000-46 amplified the “no rule” list by adding UFIs. While it studies the issue, the Service will not issue advance rulings or determination letters on (1) whether UFIs are interests in an entity not eligible for Section 1031 exchanges (i.e., an interest in a partnership or stock) and (2) whether UFI arrangements are separate entities under Section 7701.

In the Rev. Proc., the Service requested comments on (1) the terms of any leasing or management agreements and the relationships between the parties and the promoter; (2) the terms of any agreements between the promoter 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 greeted as a favorable sign that the Service might bless such arrangements, although it simply adds UFIs to the “no rule” list. 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. 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.

As a matter of federal tax law, the answer may depend upon the exact terms of such arrangements. Is there a trade, business, financial operation or venture? If so, who carries it on? Should the activities of the promoter be attributed to the holders of the UFIs? Are any “additional services” provided to tenants (or owners)? 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., Bussing v. Commissioner, 89 T.C. 1050 (1987); PLR 8330093; PLR 8046064. What, if anything, distinguishes these arrangements from traditional co-ownership of property that is rented, leased, kept in repair and maintained and 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; McShain v. Commissioner, 68 T.C. 154 (1977). Are these differences significant?

Interestingly, the Rev. Proc. only addresses whether the UFI is an interest in a separate tax entity (and thus constitute excluded property as stock or a partnership interest). The Rev. Proc. does not mention the exclusion under Section 1031(a)(2)(C) for “other securities or evidences of indebtedness or interest.” UFIs might not be interests in separate tax entities and still be disqualified as a “security.” It was reported that the staff of the Securities and Exchange Commission, which has no jurisdiction over the issue under Section 1031, views UFIs 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 UFIs 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. We have not located any meaningful 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) (proprietary 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).

More traditional UFIs were involved in PLR 200019014 (February 10, 2000), released on May 12, 2000. In that ruling, six commonly-owned partnerships will exchange their interests in mobile home parks for tenancy-in-common interests in apartment complexes. The Service ruled that a new partnership will not be formed as a result of owning the apartment complexes as tenants in common. The corporate general partner of all six partnerships will manage the apartment complexes. But the corporation will furnish only those services which are customary in connection with the rental, repair and maintenance of the properties, such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, cleaning of public areas and trash removal, and will not render any “additional services” to tenants (e.g., attendant parking, cabanas, maid service, for-profit laundry facilities, etc.). Accordingly, the Service held that the partnerships would be treated as co-owners of the apartment complexes and not partners under Section 761. Thus, the exchange for the tenancy-in-common interests would qualify under Section 1031.

The Service cited Rev. Rul. 75-374, 1975-2 C.B. 261, involving two owners who owned undivided one-half interests in an apartment project. In that ruling, additional services, such as attendant parking and cabanas, were provided by a management company for a separate charge and the management company kept the profits from the additional services. The ruling concluded that since the management company was not the agent of the owners and the owners did not share the income earned from the additional services, the owners were not furnishing additional services, either directly or through their agent.

The exact dividing line between “customary services” and “additional services” remains unclear. But services that go beyond the customary services referred to in the above rulings may be “additional services” that cause the co-ownership to be treated as a tax partnership. This classification of the co-ownership would exclude the exchange of the interest from Section 1031 and result in recognition of gain. See Phillips & Rocca, “Exchanges By ‘Partners’ Under Section 1031” (5th Annual NRDC 1031 Conference) (May 4, 1992).

Qualified Intermediaries (QIs)

Several recent developments relate to QIs. First, proposed regulations were issued narrowing the definition of a “disqualified person” for bank members of a control group containing an investment banking or brokerage firm. See REG-107175-00 (January 17, 2001). Changes in the banking laws have been enacted, including repeal of Section 20 of the Glass-Steagall Act of 1933 and new subsection (k) added to Section 4 of the Bank Holding Company Act of 1956. As a result, banks are allowed to engage in investment banking, brokerage and other financial services. The Treasury and Service believe that, in general, banks should be permitted to serve as QIs, escrow holders or trustees. The preamble notes that “banks, as regulated institutions have historically acted in this role as neutral or independent holders of funds.” Thus, the proposed regulations provide that a bank that is a member of a controlled group that includes an investment banking or brokerage firm will not be a disqualified person merely because the investment banking or brokerage firm provided services to an exchange customer within the 2-year period before the exchange. As written, the proposed regulation applies only to banks (as defined in Section 581) and not their affiliates, but this could be a drafting oversight.

The proposed regulation would amend Reg. Section 1.1031(k)-1(k)(4) (the attribution rule) to exclude banks that are related to an investment banking or brokerage firm. Under the attribution rule, a person that is related to a disqualified person, determined by using the attribution rules of Sections 267(b) and 707(b) but substituting 10% for 50%, is also considered a disqualified person. In the absence of a change to the regulations, banks related to investment banking and brokerage firms that provided services to exchange customers in the 2-year period before the exchange would be considered disqualified persons. The regulations state that a disqualified person includes an agent of the taxpayer at the time of the transaction. An agent is deemed to include a person who has acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker within two years of the taxpayer’s transfer of the relinquished property.

If the bank itself provided the investment banking or brokerage services (and not a related firm), the proposed regulation, as written, would not apply since it deals only with the attribution rule of paragraph (k)(4) and does not change paragraph (k)(2). This entire issue could have otherwise been addressed by redefining “routine” financial services provided by a financial institution and simply excluding investment banking and brokerage services from paragraph (k)(2). But perhaps such a change would go too far for Treasury and the Service. A bank might not then be viewed as a “neutral and independent holder of funds.”

A pre-release copy of PLR 200027028 (April 10, 2000), released on July 21, 2000 was discussed at last year’s conference. The ruling involves a pre-transfer amendment to a standard exchange agreement to allow the QI to distribute funds if the exchanger, after identifying one or more replacement properties and negotiating in good faith, is unable to conclude a binding agreement to purchase the property. The Service held that such an exchange agreement would not meet the requirements of Reg. Section 1.1031(k)-1(g)(6)(iii). The ruling generated some controversy. It was perceived by some as a ruling request designed to fail and one that, ordinarily, would and should not have been sought. The QI involved in the ruling may have had a conflict of interest if it earned more income, directly or indirectly, by having the ruling fail and retaining the exchange funds. Perhaps the QI simply wanted clarification of the rule for the benefit of a client. But in that case, why not simply withdraw the ruling request when it appeared that it would fail?

Two back-to-back articles were written on PLR 200027028, which is itself unusual. See Levine, “Premature Distributions From Section 1031 Exchange Accounts - New Ruling Provides Guidance.” 93 J. Tax’n 7 (July 2000); Weller, “Early Distributions From 1031 Exchange Accounts - Another Look at a Strange New Ruling,” 93 J. Tax’n 73 (August 2000). The titles of the articles reveal the tit-for-tat. The hotly contested issue is the significance and scope that should be accorded to the ruling.

Levine defends the ruling and cautions about its expanded scope: “QIs and taxpayers who proceed to distribute the cash in any event on the theory that the ruling only deals with the ‘right’ of the taxpayer to demand cash back should do so only after taking into account the potential consequences and factors discussed herein.” Levine argues that subsequent post-transfer amendments should not be respected because they render the identification and safe harbor requirements meaningless. Further, Levine suggests that such amendments could risk criminal penalties if the transaction would qualify only if the safe harbor were applicable, citing Dobrich v. Commissioner, 188 F.3d 512 (9th Cir. 1999) aff’g T.C.M.. 1998-39 (fraudulent identification case). Levine also stated that QIs who implicitly grant their customers a “right” to receive the cash back at any time risk having all of their customers’ exchanges disallowed and may be financially unstable. Finally, Levine notes that the transaction is unlikely to be effectively rescinded for tax purposes. Ordinarily, the relinquished property would not be retransferred to the taxpayer in the same tax year so as to restore all parties to their original position without the additional cooperation of the purchaser.

Weller argues that the ruling has a very limited scope. First, it addresses a pre-transfer amendment to a standard exchange agreement (i.e., a provision in the original exchange agreement) intended to comply with Reg. Section 1.1031(k)-1(g)(6). It does not analyze a subsequent “post-transfer” or “midstream” amendment. Second, the ruling addresses only two narrow situations where a taxpayer identifies (1) multiple replacement properties *intending to acquire all of them*, and (2) *only one replacement property* but fails to negotiate a satisfactory acquisition agreement with the seller. Finally, the Service was not asked to interpret the scope of Reg. Section 1.1031(k)-1(g)(6)(iii)(A) (distribution of funds on or after the receipt of all replacement property that the taxpayer is entitled to receive under the exchange agreement).

Weller points out that a more common fact pattern than the two situations addressed in the ruling is the identification of multiple properties with the taxpayer intending to acquire *only one* of the alternative properties. He describes this situation as “bought one money left over” (BOMLO). Weller suggests that the BOMLO problem can be solved in the original exchange agreement or in the exchanger’s identification notice by providing that the QI is obligated to acquire only one of the identified properties. Following the acquisition of the first such property, the QI will have no further obligations to acquire and transfer any additional properties. The taxpayer will then have clearly received all of the replacement property that the taxpayer is entitled to receive under the exchange agreement. Reg. Section 1.1031(k)-1(g)(6)(iii)(A) should permit release of the funds after the first and only replacement property is acquired and transferred to the taxpayer.

Weller then discusses another fact pattern that he describes as “let’s forget it” (LFI). The taxpayer enters into an exchange agreement but quickly decides not to pursue any replacement property acquisition and wants the exchange funds before the end of the 45-day identification period. Or the taxpayer identifies properties, does not revoke the identification in the 45-day period, and later changes his mind, deciding not to pursue any exchange or finding that none of the properties can be acquired. Weller acknowledges that this is a “potentially tougher problem” than the BOMLO situation. He suggests that a midstream amendment to the exchange agreement might be legitimate in the LFI situation, particularly in the case where the QI would no longer be obligated to acquire any of the identified properties.

Weller states: “In no public or private forum have government officials indicated that the deferred exchange Regulations should put QIs in a position where they must keep taxpayer funds beyond the point where a taxpayer is prepared to walk away from Section 1031 treatment and treat a transaction as a sale. The creation of the mechanical rules relating to QIs as a safe harbor from constructive receipt of replacement property sales proceeds is in no way inconsistent with the right of the parties, following implementation of a safe harbor structure, to change their minds about its maintenance. Particularly where separate consideration is paid to a QI to support amendment of an exchange agreement in a LFI circumstance, the legal basis for the IRS to challenge the exchanges of other customers of the QI, who neither requested such an amendment nor paid consideration to obtain it, seems fragile. The IRS has sometimes based its positions on theories that private practitioners may believe are fragile. No QI is likely to want to be the test case in this area. Thus, despite the potential legitimacy of the suggested technique, we may have

to wait for a published or private ruling to know whether the contract amendment approach is truly safe.”

Weller’s view of a post-transfer amendment is consistent with our own. Far from potentially subjecting QIs and taxpayers to “criminal penalties” as suggested by Levine (an incredible and irrational suggestion in our view), a post-transfer amendment should be legitimate and is supported by bone fide business considerations. There is no tax abuse or evasion involved. The taxpayer is obligated to report the failed exchange as a taxable sale, just as much as if he waited the full 180 days to receive the exchange funds. There is simply no good legal, policy or other reason to prohibit such amendments, provided that they are not a fait accompli at the inception of the transaction. Only in that case would such amendments render the identification and safe harbor requirements meaningless. These issues are further discussed in our separate article, “The Problem of Failed Exchange,” in this year’s program

On March 23, 2001, the Eleventh Circuit, in an unpublished per curiam opinion, affirmed the Tax Court’s opinion in Florida Industries Investment Corporation and Subsidiaries v. Commissioner, T.C. Memo 1999-346. The only issue on appeal involved the rollover of condemnation proceeds under Section 1033 in a separate transaction from the exchange and the related penalties. The taxpayer did not appeal the court’s holding with respect to the Section 1031 exchange. Florida Industries was discussed extensively in our article last year. See Phillips & Rocca, “Fatal Departures: Beware of Straying From the Terms of an Exchange Agreement” (13th Annual NRDC 1031 Conference April 27, 2000).

Although the accommodator in Florida Industries was a disqualified person (the taxpayer’s attorney), the case has major significance for QIs. It holds that violating the terms of an exchange agreement and allowing the premature release of exchange funds may evidence constructive receipt of the entire exchange balance ab initio and cause the entire transaction to be taxed. In Florida Industries, even the first replacement property, which was received the day after the transfer of the relinquished property and before the taxpayer prematurely received exchange funds, failed to qualify for nonrecognition treatment. Levine’s article surprisingly does not discuss Florida Industries. Weller’s article notes the potential application of the case to fact patterns like those presented in PLR 200027028: “*Florida Industries* illustrates that the wages of sin (i.e., ignoring the (g)(6) limitations contained in agreements) are damnation (i.e., loss of Section 1031 tax deferral).”

As noted by Weller and also in our “Fatal Departures” article, Florida Industries, like PLR 200027028, should not be taken out of its limited context. This case and the ruling do not address a bona fide midstream amendment to an exchange agreement. The court in Florida Industries specifically noted that the parties to the escrow agreement never modified, amended or supplemented the agreement. Moreover, the court stated that “it is significant that the escrow agreement did not identify what portion of the escrowed sales proceeds was to be used to purchase replacement property and what portion was to remain as boot under Section 1031.” Thus, the question remains open as to whether an agreement can be modified to provide for the

release of funds without prejudicing Section 1031 treatment for replacement properties previously received.

FSA 200048021 (August 29, 2000), released on December 1, 2000, involved an escrow agent who did not satisfy the definition of a QI. Among other things, the escrow agent did not acquire or transfer the properties involved in the exchange. The FSA concerns a father who transferred the relinquished property to his children and attempted an exchange. While an exchange agreement was drawn up with a party acting as “escrow agent,” it appears that the agreement was never followed. The children paid the purchase price to the taxpayer’s law firm, not the escrow agent. The taxpayer was then in constructive receipt of the sales proceeds since the law firm, as the taxpayer’s agent, received the funds prior to the taxpayer’s receipt of the replacement property. The terms of the exchange agreement were also deemed to violate the (g)(6) limitations. The agreement may have been interpreted to allow for the taxpayer to obtain funds prior to the receipt of replacement property if a sales contract was presented to the taxpayer but the taxpayer rejected it after the 45-day identification period. See also PLR 200027028 (taxpayer’s inability to enter into a binding agreement to acquire replacement property after negotiating in good faith is not a contingency “beyond the control of the taxpayer” or otherwise a (g)(6) event).

PLR 20010922 (November 29, 2000), released on March 2, 2001, involves a very interesting exchange program for equipment. The taxpayer (T) acquires and disposes of large volumes of equipment and entered into a master exchange agreement with a QI that is a third-party financial institution. The parent of the QI and its affiliates provided routine financial services to T and its affiliates, including funds processing, lines of credit, lockbox services, counterparties in foreign exchange swaps and purchases of taxpayer-issued debt obligations. These services were viewed as routine and QI was not deemed to be a disqualified person. The ruling illustrates a very clever mass exchange program that was held to meet the requirements and safe harbors of the deferred exchange regulations. Within the 45-day identification period, old and new equipment were matched (apparently by computer program using certain parameters) to minimize boot and create a separate and distinct like-kind exchange for each match.

T and QI used the “assignment and notice” method of having QI acquire and transfer the relinquished and replacement property under Reg. Section 1.1031(k)-1(g)(4)(v). Under the master exchange agreement, T assigned its rights (but not its obligations) with respect to the sale of all equipment on the date the agreement was signed as well as equipment acquired by T in the future. Similarly, T assigned to QI its rights to purchase new equipment, including equipment acquired after the agreement was signed. In addition to these assignments of future equipment, T notifies QI of individual transactions by sending QI a report containing a listing of daily acquisitions and dispositions of equipment. The reports provide QI with a list of each transaction with respect to which QI has been assigned T’s rights.

T provides notice to purchasers of the relinquished property and sellers of the replacement property in two different ways. First, T sent a blanket notice to the other parties

prior to the start of the like-kind exchange program. Second, T provides a purchaser or seller with a written notice in connection with each disposition of a relinquished property and each acquisition of a replacement property on or before the date of each transaction. The Service held that this system satisfied the “assignment and notice” method of having the QI acquire and transfer the properties.

Information about the old and new equipment is analyzed in T’s like-kind exchange matching system, and relinquished property is matched to replacement property according to certain parameters. Properties are matched only if the replacement property is acquired within 45 days after the transfer of the relinquished property to the purchaser. Further, to the extent possible, relinquished property is always matched with replacement property whose cost equals or exceeds the proceeds from the sale of the relinquished property. Where this is not possible, the matching system is designed to group property so that excess of proceeds over costs (i.e., boot) is minimized. The Service held that this matching program will create a separate and distinct like-kind exchange for each match of properties.

A system of collections is used that results in proceeds from the sale of relinquished property being used by QI to purchase replacement property. At no time will the proceeds be placed in an account over which T has the power to obtain the funds, directly or indirectly, without QI’s consent. The replacement property is then purchased by QI using the sales proceeds one day after and no later than 45 days after the transfer of the related relinquished property. If the proceeds are insufficient, T transfers additional funds to cover the shortfall. Unspent proceeds remaining in the account are invested by QI in accordance with T’s instructions. Any income earned is reported by T for tax purposes. See Reg. Section 1.1031(k)-1(h). These earnings on the unspent proceeds are used by QI to acquire replacement property in the future. T’s rights with respect to the income are restricted in accordance with the (g)(6) limitations. Apparently, the QI or its affiliates also processed funds for non-like-kind exchange transactions. This processing was kept sufficiently separate from the exchange program so as to avoid any adverse impact.

The master exchange agreement addressed the cash flows in T’s exchange program and expressly provided for the (g)(6) limitations. T identified replacement property solely by receiving it before the end of the 45-day identification period as provided in Reg. Section 1.1031(k)-1(c)(1). This system avoided the problem of sending a written identification notice specifying multiple or alternative properties to be acquired in the future and the associated matching complications. If no replacement property is received with respect to a particular relinquished property within the identification period, the agreement permits T to receive the related proceeds from the sale of that relinquished property after the end of the identification period in accordance with Reg. Section 1.1031(k)-1(g)(6)(ii). In such a case, T recognizes all realized gain from the sale of that relinquished property. Similar provisions are contained in a bank account agreement, and the approval of QI is required for each transfer of funds.

The Service held that the agreements concerning the flow of funds restrict T’s rights in accordance with the (g)(6) limitations. Further, T will not otherwise have constructive receipt of

the proceeds from the sale of relinquished property. In each type of transaction, QI receives the full amount of proceeds from the sale of relinquished property, no funds can be used without QI's approval, and the agreements properly limit T's rights. Apparently, T receives other funds in separate and distinct arm's length transactions from the sale of the relinquished property, but this will not result in actual or constructive receipt of the sales proceeds. The Service cited 124 Front Street v. Commissioner, 65 T.C. 6 (1975), acq. 1976-2 C.B. 2 (taxpayer received loan advance from transferee to acquire relinquished property and later exchanged the property). Thus, the Service fully approved T's mass exchange program. PLR 200109022 provides a relatively simple, efficient and sophisticated model for an exchange program involving large volumes of equipment.

Miscellaneous Cases and Rulings

We now turn to a summary of the issues presented in other cases and rulings since our last conference. The issues involve: (i) basis received in replacement property; (ii) intangible property; (iii) debt issues, including a pre-exchange refinancing and the agreed allocation of liabilities among co-owners; (iv) Section 1031(f) and a related party purchaser of relinquished property; (v) the exchange of land for a purchase option and the holding issue; and (vi) other special issues.

1. Bundren v. Commissioner, T. C. Memo 2001-2, involves the determination of basis in replacement property following a like-kind exchange for purposes of depreciation and gain or loss on the subsequent sale of the replacement property. The facts are unusual in that the taxpayer (T) effected an exchange with another party when T was deemed to have no taxable gain in the property. In September 1994, T converted a personal residence to rental property when it could not be sold due to market conditions. The property was rented for 4 months for a few hundred dollars a month before the exchange. T had an investment of \$233,130 in the property (original cost plus improvements) at the time it was used as a residence. After 4 months of renting the property, T decided to dispose of it and listed it for sale at \$134,500.

Another party (X) had a property for sale for \$67,500. T and X exchanged properties on December 30, 1994 using the full listing prices. The exchange was treated as essentially one transaction but the terms were shown on the settlement statements as if T sold his property for \$134,500 and X sold her property for \$67,500. The Service and T stipulated that the exchange qualified under Section 1031, even though the property was rented for only 4 months after the conversion from a personal residence.

In 1996, T sold the replacement property for \$61,600 and incurred \$10,668 in selling costs. T did not mention the exchange on his 1994 and 1995 returns. T claimed depreciation of \$5,186 with respect to the replacement property on his 1995 return. On his 1996 return, T claimed a \$159,820 loss on the sale of the replacement property. The Service determined that T's basis in the replacement property immediately after the exchange was \$67,500. Using this basis, the Service recomputed the depreciation for 1995 to be \$1,650 and the deductible loss on sale to be \$13,406.

The court noted that, at the time of the conversion of the residence to rental property in September 1994, T's basis was equal to the lesser of (i) the then fair market value of the property or (ii) the adjusted cost basis of the property. The court cited Heiner v. Tindle, 276 U.S. 582 (1928); Higgins v. Commissioner, T.C. Memo 1995-139; Frahm v. Commissioner, T.C. Memo 1974-138; Reg. Section 1.165-9(b)(2). This rule prevents the deduction of an otherwise nondeductible personal loss following the conversion of personal use property to business or investment property. All parties agreed that the fair market value of the property on the date of the conversion was less than T's adjusted cost basis (which was at least \$233,130), but the question was what was the fair market value of the property upon the conversion in September 1994.

In the absence of any other credible evidence, the court sustained the Service's determination that the then fair market value, and thus the basis at the time of conversion in September 1994, was \$134,500. This is the same amount that the relinquished property was valued at in December 1994 for purposes of the exchange. The court then found that T's basis in the replacement property was \$67,500. This is the same amount that the replacement property was valued at in December 1994 for purposes of the exchange. This basis is equal to (1) the basis in the relinquished property immediately before the exchange (\$134,500), decreased by (2) any money or other property (boot) received (T had mortgage relief) and adjusted for (3) any gain or loss recognized on the exchange (zero). The Service determined that the net boot received was \$67,000, and thus T had a basis of \$67,500 in the replacement property. T disagreed with the computation of boot, but the court ruled in favor of the Service.

The answer is clear if you view the transaction as a purchase of the replacement property by T and disregard the exchange (which was meaningless on these facts). T traded down in value and had no taxable gain. Thus, T's basis in the replacement property was deemed to equal its value and cost (\$67,500) just as if the transaction was simply a purchase of the replacement property. To the \$67,500 basis, the court added \$10,668 in closing costs that the Service conceded should be added to basis and redetermined T's deductible loss on sale. The court did not impose the accuracy-related penalty. The court found that the tax issues were relatively complex and that T lacked experience and training in such matters and reasonably and in good faith relied on his accountant.

The moral of Bundren is that tax basis is not always cost, particularly when property has been converted from a personal residence in a declining market. Another lesson is that an exchange under Section 1031 may not be advisable when the taxpayer has no taxable gain and may in fact have a loss. A loss on a Section 1031 exchange cannot be recognized. See Section 1031(c); Reg. Section 1.1031(c)-1.

2. TAM 200235005 (May 11, 2000) approved an exchange of a radio license for a television license, finding the licenses to be of like kind under Reg. Section 1.1031(a)-2(c)(1). The TAM examined (1) the nature or character of the rights involved (finding the rights conferred on an FCC licensee to be basically the same, despite differences regarding the specific terms and conditions of operation with respect to radio and television licenses); and (2) the

nature or character of the underlying property (finding the “underlying property” to be the assigned frequency of the electromagnetic spectrum referred to in each license). The TAM did not view the “underlying property” as the entire array of assets of a radio or television station as suggested by the examining agent. Nor did it consider the “underlying property” to be the tangible personal property referred to in the licenses, such as transmitters, towers and antenna, which are described in the same Produce Class in the SIC Manual. The TAM noted that the FCC license principally relates to the use of the radio transmitting apparatus, rather than the apparatus itself. Although radio and television broadcasts are assigned to different frequency bands, television broadcasts require a considerably larger bandwidth and a licensee would be in violation of its license if it used a television frequency to broadcast radio transmissions and vice versa, the TAM found these to be merely differences in grade or quality. The TAM stated that “even the narrowest interpretation of the like kind standard does not require that one property be identical to another or that they be completely interchangeable.”

3. PLR 200019014 was discussed above concerning the co-ownership versus partnership issue but is also worth noting because the ruling involved pre-exchange refinancing and an agreed allocation of debt on the replacement property.

a. Pre-exchange refinancing. The taxpayers refinanced mortgages on the relinquished properties in July of Year 1 to take advantage of lower interest rates, and some of the proceeds of the refinancing were distributed to the partners to purchase other properties. The taxpayers represented that they did not contemplate the exchanges at the time of the refinancing and were first approached concerning the exchange transactions in February of Year 2.

The Service ruled that the proceeds of the refinancing will not be considered cash boot in the exchange because “the refinancing in Year 1 had an economic significance that is independent from the proposed exchange” (i.e., lower interest rates on the new loans and the use of the refinancing proceeds to purchase more properties).

The Service followed Garcia v. Commissioner, 80 T.C.491 (1983), acq. 1984-2 C.B. 1 (test is whether debt has “independent economic substance”) and Fredericks v. Commissioner, T.C. Memo 1994-27 (although refinancing occurred after exchange agreement was entered into, taxpayer had reasons for the refinancing that were unrelated to the exchange, namely, to obtain a lower interest rate and the fact that the original loan was due shortly). Compare Reg. Section 15A.453-1(b)(2)(iv) (excluding debt incurred in contemplation of the disposition of property from “qualifying indebtedness” for purposes of the installment sale rules); Long v. Commissioner, 77 T.C. 1045 (1981) (reallocation of partners’ liabilities within six weeks before exchange disregarded); Behrens v. Commissioner, T.C. Memo 1985-195 at n. 13 (step transaction and substance over form doctrines may apply to a pre-exchange refinancing that is part of the exchange); PLR 8434015 (May 16, 1984) (loan proceeds received in anticipation of an exchange treated as cash boot);

b. Agreed Allocation of Debt. All of the taxpayers (six partnerships which will own the replacement properties as tenants in common) will be required to be jointly and

severally liable for the mortgages on the replacement properties. The partnerships will enter into a “debt-sharing agreement” which will (i) allocate the risk of loss among the partnerships so as to “ensure that the amount of each partnership’s debt is not reduced by the exchange,” (ii) obligate each of the partnerships to make sure its proportional share of payments on the loans is secured by the replacement properties, and (iii) obligate each of the partnerships to indemnify the other partnerships against any failure to make such payments. The Service ruled that the joint and several obligation of the partnerships to pay the entire amount of the mortgages “will not result in a reduction in any partner’s share of partnership debt.” It is unclear exactly what this ruling means since the partnerships were held to be co-owners of the replacement properties, not partners in a deemed partnership. Instead, this ruling seems to apply to the individual partners of the six partnerships (i.e., that they will avoid any debt relief under Section 752) as a result of the exchange and the debt-sharing agreement. In any event, the Service respected a debt-sharing agreement that was designed “to ensure that the amount of each partnership’s debt is not reduced by the exchange.”

This ruling supports the special allocation of debt by agreement among co-owners, even though a loan provides for joint and several liability. The debt-sharing agreement did not cause the co-owners to be treated as partners in a partnership, even though it may have specially allocated the loan liabilities to avoid the receipt of boot by each co-owner. This is the sensible result. Nothing in the Section 761 regulations should preclude co-owners from having an agreement concerning their proportionate shares of a blanket liability.

Further, for purposes of Section 1031, the liability should be allocated among the co-owners in accordance with their debt-sharing agreement (assuming the agreement is bona fide and has economic substance). In other words, the liability should be allocated based on how the parties themselves reckon with it, who pays it and who bears the economic risk of loss. To determine this, the agreement of the parties must be taken into account. This is consistent with the principles of the Section 752 regulations, although such regulations do not apply to co-owners or for purposes of Section 1031. See, e.g., PLR 7935126 (June 4, 1979) (allocation of liabilities based on who actually bears the liability and risk of loss, not necessarily the owner of the property that secures the liability); Platner, “Special Issues Involving Liabilities in Section 1031 Exchanges,” 17 Real Est. Tax Digest 55 (February 1999), reprinted (12th Annual NRDC 1031 Conference March 29, 1999).

4. FSA 200048021 was discussed above concerning the QI and constructive receipt issues but the FSA also signals the Service’s views on an issue under Section 1031(f) when a related party purchases the taxpayer’s relinquished property. In the facts of the FSA, a father was deemed to sell the relinquished property to his children and not exchange with them. Accordingly, Section 1031(f) did not apply to the transaction, although the children disposed of a “small portion” of the property within the 2-year holding period of Section 1031(f)(1).

But the FSA goes on to opine that, even if the taxpayer exchanged the relinquished property with his children and the transaction qualified for nonrecognition treatment, the transaction would not qualify for the non-tax avoidance exception of Section 1031(f)(2)(C). The

Service then analyzed the facts and found that basis shifting occurred. The father transferred his low basis to the replacement property and the children, as purchasers of the relinquished property, took a high (cost) basis therein. The children would recognize little or no gain on the sale of small portions of the relinquished property in the 2-year period, as compared to the “considerable gain” that the father would have recognized if he had sold the property. The Service did not comment, however, on the effect of selling only “small portions” of the relinquished property in the 2-year period. Would all or only an allocable part of the father’s gain have to be recognized in the year of the subsequent disposition?

When a related party acts solely as the cash purchaser of the relinquished property, Section 1031(f)(1) may not apply if no direct exchange is made “with” the taxpayer. The taxpayer may instead be exchanging with a QI or an unrelated seller of the replacement property. However, we have argued that Section 1031(f)(4) presumptively applies to such a transaction and the exchange is taxable if the related buyer disposes of the relinquished property in the 2-year period. This is the case even if Section 1031(f)(1) does not apply because there is no formal exchange between related persons. The FSA indicates that the Service also has this view. For extensive analysis of this issue, see Rocca & Phillips, “Related Party Exchanges” (11th Annual NRDC 1031 Conference April 16, 1998) at 63-67.

The argument against the application of Section 1031(f)(4) to this transaction is as follows. “Not every transaction ‘touched’ by a related party is a related-party exchange. If the replacement property is never owned by a related party, its transfer to a taxpayer via a qualified intermediary should not be affected by a related party’s purchase of the relinquished property. There is no abusive basis shift because the related party’s purchase involves creation of a new cost basis rather than a carryover.” See Question 20 of the American Bar Association Comments Concerning Open Issues in Section 1031 Like-Kind Exchanges (“ABA Comments”), as reported in Long and Vrbanac, Tax-Free Exchanges Under Section 1031 (West Group 1997) (Appendix 9A).

But, we believe that those who argue or assume that Section 1031(f) does not apply to this fact pattern are mistaken. Even if the related party is merely a cash purchaser of the taxpayer’s property, both parties should hold their properties for 2 years to avoid Section 1031(f). Our conclusion is strongly reinforced by TAM 9748006. That transaction could have been structured as follows: Instead of purchasing her residence, the mother (the related party) could have purchased the taxpayer’s land (the relinquished property) from the QI (giving the mother a cash basis therein). The QI could have purchased the residence and transferred it to the taxpayer, and the mother could have then sold the land to the buyer recognizing little or no gain. At the end of this transaction, the parties are in exactly the same position as the actual fact pattern in TAM 9748006: the mother has the cash, the taxpayer owns the residence and the buyer owns the land.

There is little or no doubt, in our view, that the Service will treat cases in which a related party purchases the relinquished property and sells it in the 2-year period in the same way as the

transaction in TAM 9748006. To do otherwise would be logically inconsistent, and would elevate form over substance in contravention of Section 1031(f)(4).

5. FSA 1995-12 involves a partnership exchanging land for an option to acquire land. The Service concluded that the exchange of land for an option to acquire land does not necessarily disqualify the transaction under Section 1031. The Service indicated that a land purchase option may be of like kind to a fee interest in land, citing Koch v. Commissioner, 71 T.C. 54, 65 (1978), acq. 1979-1 C.B. 1. The FSA also cites the action on decision in Koch (O.M.. 70336, May 16, 1979), stating that “[i]t is the Service’s position that an investment in land is of like kind to any other investment in land.” See 1979-1 C.B. 1. See also Rev. Rul. 92-105, 1992-2 C.B. 204.

However, the FSA went on to conclude that the transaction was defective on a more significant basis since the partnership terminated and a corporation succeeded to its rights under the option contract. The Service concluded:

“Like the taxpayers in Rev. Rul. 77-337, 1977-2 C.B. 305, and Rev. Rul. 75-292, 1975-2 C.B. 333, the partnership here never intended to hold the property for a qualifying purpose. Indeed, the partnership here had already dissolved even before the actual transfer was made. By definition, therefore, it could not have held the exchange property for a qualifying purpose under the statute. Similarly, [the Corporation] cannot merely step into the shoes of the partnership for section 1031 purposes notwithstanding its ability to exercise purely contractual rights or obligations. A transferee of exchange property does not automatically acquire the transferor’s attributes.”

6. Other recent rulings involved more esoteric issues and are very briefly noted. PLR 200041027 (July 19, 2000) held that signs could be exchanged for real property under Section 1031. The signs met the definition of an outdoor advertising display and an election with was made to treat the signs as real property under Section 1033(g). The election would not change the 15-year recovery period of the signs as depreciable “land improvements” under Section 168. PLR 200040017 (June 30, 2000) held that real property located in the Virgin Islands may be exchanged for U.S. real property, notwithstanding the provisions of Section 1031(h) (foreign and U.S. real property not of like kind) and Section 7701(a)(9) (the term “United States” includes only the States and the District of Columbia). However, this treatment only applies if Section 932 applies to the taxpayer. For the year of the exchange, the taxpayer must be (1) a citizen or resident of the United States and have income derived from or effectively connected with a business in the Virgin Islands or (2) file a joint return with a person who meets these requirements.

In conclusion, recent developments in reverse exchanges have made such transactions much safer from a tax point of view, including safe harbor parking transactions under Rev. Proc. 2000-37 and non-safe-harbor parking transactions following PLR 2000111025. Another major victory was achieved by the Section 1031 exchange community. The reverse exchange

pronouncements follow the liberal rules for a qualified intermediary under the deferred exchange regulations. But these victories may have a price in light of the recent proposal by the staff of the Joint Committee of Taxation to eliminate the exchange requirement under Section 1031 and enact a 180-day rollover provision. The staff argues that the rules have become so liberal that a rollover provision would not be substantively different than modern exchanges. Further, the staff contends that intermediary arrangements are complex and increase transactions costs. Thus, after receiving great news on reverse exchanges, the QI industry is now threatened with a proposal to kill it. The battle continues and now moves from the Service to Congress.