REAL ESTATE

The 'State of the Art' in Like-Kind Exchanges, Revisited

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The nonrecognition provisions of Section 1031 might be thought of as one of the few legitimate "tax shelters" left, and so it is of critical importance that its requirements be met by taxpayers seeking to qualify. The IRS has been extremely active in this area in the past few years, offering new safe harbors and taking positions that on the whole are favorable to taxpayers. Nevertheless, there are many potential planning opportunities and problem areas, as well as unresolved issues that could benefit from additional guidance.

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Section 1031(a) is frequently used by taxpayers to defer gain on exchanges of real property and other like-kind property swaps. An article in THE JOURNAL four years ago reviewed the manner in which tax practitioners were addressing the most frequently asked questions concerning like-kind exchanges, and set forth common-sense methods for tax advisors to structure such exchanges. 1

In the tax law, four years is a long time, and there have been many significant changes in the rules concerning like-kind exchanges during that time. The most important are the new rules from the IRS concerning reverse exchanges and tenancy-in-common transactions. 2 This guidance, however, has given rise to other questions that now confront most practitioners. In addition, some of the questions that

were addressed four years ago remain unanswered, although practitioners are becoming more comfortable with how such transactions should be structured. The most frequently asked questions involve:

- How "safe" is the safe harbor for reverse exchanges in Rev. Proc. 2000-37, 2000-2 CB 308?
- How will safe harbor reverse exchanges be treated for state and local income and transfer tax purposes?
- Can safe harbor reverse exchanges be converted into non-safe harbor transactions?
- Can a taxpayer acquire replacement property from a related party?
- Can a taxpayer use the reverse exchange rules to implement an exchange with a related party?
- Can a taxpayer encumber replacement property immediately after it is acquired?
- What happens if a taxpayer encumbers relinquished property in contemplation of an exchange?
- How does Section 1031 apply to individuals living in community property states?
- Is compliance with all of the requirements in Rev. Proc. 2002-22, 2002-1 CB 733, required for a tenancy-in-common interest to be treated as an interest in real estate (and not as an interest in a partnership)? If not, which requirements are the most important ones?
- If relinquished property is held by a partnership, how can some of the partners receive cash while other partners receive replacement property?
- Can a taxpayer exchange property received in a distribution from a partnership (a "drop and swap" transaction)? Can a taxpayer who receives replacement property in an exchange immediately transfer the property to a partnership (a "swap and drop" transaction)?

FORWARD EXCHANGES

Under Section 1031(a), no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment. 3 Thus, there are four requirements for a tax-free exchange:

(1) There must be an "exchange."
(2) The exchange must be of "property" of a type that qualifies under Section 1031. 4

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(3) The replacement property must be of like-kind to the property relinquished.
(4) Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

The general rule in Section 1031(a) requires that qualifying property must be exchanged *solely* for other qualifying property. Section 1031(b) provides, however, that if an exchange otherwise would be eligible for tax-free treatment under Section 1031(a) but for the receipt of cash or nonqualifying property (boot), any gain realized on the exchange is recognized to the extent of the boot received. 5

Liabilities. Taxable boot includes relief from liabilities. Reg. 1.1031(d)-2 expressly permits a taxpayer to determine whether liabilities have been relieved using a "netting" concept, under which the taxpayer's liabilities that are assumed or taken subject to by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering his relinquished property also may be offset by cash given by the taxpayer to the other party. **6**

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

Related parties. Special rules apply if an exchange involves related parties. Under Section 1031(f), if a taxpayer obtains nonrecognition treatment on an exchange of property with a related person, **7** that treatment will be lost if the taxpayer or the related person disposes of either property within two years. The two-year period will be suspended under Section 1031(g) during any period in which any of the exchanged properties is subject to a put, a call, a short sale, or a transaction with similar effect.

Multiparty and deferred exchanges. It is fair to say that Congress probably believed initially that like-kind exchanges would apply only to simultaneous transfers between two persons. The law quickly evolved, however, to allow both multiparty exchanges as well as deferred exchanges.

In a typical multiparty exchange, the taxpayer holds relinquished property that is sold to a buyer. The buyer acquires the replacement property desired by the taxpayer from a seller, who conveys the replacement property to the taxpayer on behalf of the buyer. Although the IRS initially argued that such three-party exchanges did not satisfy Section 1031, after losing in court **8** the Service eventually capitulated.

A significant outgrowth of the rules permitting multiparty exchanges are the Regulations allowing deferred exchanges. These exchanges are often referred to as *Starker* transactions after the Ninth Circuit decision that first sanctioned such arrangements. In *Starker,* 44 AFTR 2d 79-5525 602 F2d 1341 79-2 USTC ¶9541 (CA-9, 1979), the taxpayer transferred property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date.

In response, Congress enacted Section 1031(a)(3), which allows the transferor of the relinquished property up to 45 days to identify the replacement property and 180 days to close on the acquisition of the replacement property. The taxpayer may identify any three properties or multiple properties with an FMV not in excess of 200% of the FMV of the relinquished property. **9** Most taxpayers prefer to use the three-property rule because of the certainty it engenders. **10**

Much has been written about the Regulations that permit taxpayers to engage in deferred like-kind exchanges. 11 Basically, these Regulations set forth detailed (and generally taxpayer-friendly) guidance concerning how a

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taxpayer can comply with the deferred-exchange requirements in Section 1031(a)(3). Most important, the Regulations contain safe harbors that taxpayers can use to avoid constructive receipt of the proceeds from the relinquished property. These safe harbors have resulted in the creation of an entire industry-qualified intermediaries (QIs) and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under Section 1031.

Even though these rules are well established, change is possible. Legislation has been proposed that would, for simplification reasons, eliminate the need for QIs in like-kind exchanges. 12 Under this legislation, a taxpayer could engage in a like-kind exchange if the taxpayer merely reinvested the proceeds of a sale of the relinquished property in replacement property within the appropriate period (similar to the rollover rule that used to apply to principal residences under former Section 1034). This approach would be simpler but also would be quite different. Only time will tell whether there will be a significant change to the rules for forward exchanges.

REVERSE EXCHANGES

Until three years ago, the more difficult question was whether a taxpayer could enter into a reverse exchange, which arises when a taxpayer acquires replacement property *before* disposing of the relinquished property. A positive answer from IRS came with the issuance of Rev. Proc. 2000-37, which sets forth a safe harbor for reverse exchanges.

In the Procedure, the Service recognized that taxpayers had been using a wide variety of "parking" transactions to facilitate reverse exchanges. In the interest of sound tax administration, the IRS wanted to provide taxpayers with a workable means of qualifying a reverse exchange under Section 1031 if the taxpayer has a genuine intent to accomplish a like-kind exchange at the time the taxpayer arranges for the acquisition of the replacement property, provided that the taxpayer actually accomplishes the exchange within a short time thereafter.

Accordingly, Rev. Proc. 2000-37 provides a safe harbor that allows a taxpayer to treat the exchange accommodation titleholder (EAT) as the owner of property for federal income tax purposes, thereby enabling the taxpayer to accomplish a reverse exchange. The new rule is effective for transactions entered into after 9/14/00.

Prior to the issuance of Rev. Proc. 2000-37, reverse exchanges were usually accomplished using an accommodation party (AP) who was required to make an investment in property in order to avoid characterization as a mere agent of the taxpayer. The investment by the AP depended on whether the

transaction was structured as a swap-last exchange, in which the AP acquired and held the replacement property until the taxpayer found a purchaser for the relinquished property, or as a swap-first transaction, in which the taxpayer entered into an exchange for the replacement property immediately, and the AP acquired the relinquished property until a purchaser could be found. **13**

The IRS did not distinguish between swap-first and swap-last transactions in Rev. Proc. 2000-37. Although most reverse exchanges are structured using the swap-last format (because the taxpayer may want 45 days to identify the relinquished property), **14** the IRS did not insist that taxpayers use one or the other approach in order to achieve a nontaxable reverse exchange. Furthermore, the fact that a transaction falls within this safe harbor is taken into account solely for purposes of applying Section 1031 and has no impact on any other federal income tax determinations.

Also, the Service emphasized that no inference was intended in Rev. Proc. 2000-37 with respect to the transactions not covered by the safe harbor. Thus, the IRS specifically recognized that parking transactions could be accomplished outside of the safe harbor. If the safe harbor requirements are not satisfied, the determination of whether the taxpayer or the EAT is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by the parties, will be made without regard to the safe harbor. The IRS further indicated that no inference should be drawn with respect to parking transactions entered into prior to the Procedure's effective date.

The QEAA

The fundamental concept underpinning the safe harbor in Rev. Proc. 2000-37 is a qualified exchange accommodation agreement (QEAA). The IRS will not challenge the qualification of property as either replacement property or relinquished property for purposes of Section 1031, or the treatment of the EAT as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA. Property is held in a QEAA if the six requirements below are satisfied.

1-Ownership. "Qualified indicia of ownership" of the property must be held by an EAT who is not the taxpayer or a disqualified person **15** at all times from the date of acquisition by the

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EAT until the property is transferred (as described below).

The EAT must be subject to federal income tax or, if the EAT is a partnership or S corporation for federal income tax purposes, more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax.

For purposes of this rule, qualified indicia of ownership includes:

- Legal title to the property.
- Other indicia of ownership of property that are treated as beneficial ownership of the property

under applicable commercial law principles (e.g., a contract for deed).

- Interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (for example, a single-member LLC (SMLLC)) and that holds either legal title to the property or other indicia of ownership.

As a practical matter, in most instances this requirement will be satisfied by having the EAT either directly, or through an SMLLC, acquire legal title to the property.

2-Intent. At the time the qualified indicia of ownership of the property is transferred to the EAT, it is the taxpayer's bona fide intent that the property held by the EAT represents either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) under Section 1031.

3-Qualified agreement. No later than five business days after the transfer of qualified indicia of ownership to the EAT, the taxpayer and the EAT must enter into a written QEAA that provides that the EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37. The QEAA also must state that the taxpayer and the EAT agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37.

To satisfy this requirement, the QEAA must specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes, and both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the QEAA. (The practical impact of this requirement is discussed in more detail, below.)

4-Identification. No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the EAT, the property to be relinquished must be identified in the manner set forth in Reg. 1.1031(k)-1(c) (which permits the taxpayer to identify alternative or multiple properties). **16** Identification must be made in the manner provided in such Regulations, which presumably means that written notice must be given by the taxpayer to the EAT as to the identity of the relinquished property by no later than midnight on the 45th day after acquisition of the replacement property. Such notice must identify the relinquished property with sufficient particularity. **17**

5-Sale. No later than 180 days after the transfer of qualified indicia of ownership of the property to the EAT, either (1) the property is transferred (directly or through a QI) to the taxpayer as replacement property, or (2) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property. The transfer of the property to the taxpayer as replacement property covers a swap-last transaction, in which the EAT acquires and holds the replacement property. In contrast, the transfer of the property to an unrelated person applies in a swap-first transaction, where the AP acquires the relinquished property and holds it for later sale.

6-Timing. The combined time period that the relinquished property and the replacement property are held in a QEAA cannot exceed 180 days. It is not clear whether this provision also requires

the taxpayer to irrevocably dispose of the relinquished property at the same time.

EXAMPLE: In a swap-last transaction, the EAT establishes an SMLLC that borrows $100,000 to acquire the replacement property on day 1. The relinquished property is properly identified on day 45, and the relinquished property is conveyed to the SMLLC on day 180 in exchange for the replacement property in a transaction in which the SMLLC remains liable on the debt. Simultaneously, title to the SMLLC (which holds the relinquished property and is subject to the debt) is transferred to a QI, which holds the SMLLC for 180 days. At that time (360 days after the initial closing), the relinquished property is sold to a third party, whose cash is used to pay off the loan initially used to acquire the replacement property.

This transaction appears to satisfy the requirements of Rev. Proc. 2000-37 because the replacement property is held by an EAT for only 180 days; the relinquished property is then held by a QI for 180 days. It is not certain, however, that the Service contemplated that the sale of the relinquished property might not occur for 360 days.

Flexible Arrangements

From a practical standpoint, the most important aspect of Rev. Proc. 2000-37 may be the flexibility that it gives to taxpayers and EATs in setting up the accommodation arrangement.

Under prior law, the AP had to have a sufficient ownership stake in the property in order for the taxpayer to avoid constructive receipt. This generally meant that the AP had to make an economic contribution to the acquisition of the property. Typically, the AP would be required to contribute at least 5%, and sometimes up to 20%, of the cost of the replacement property (or, in a swap-first transaction, the relinquished property) that the AP would acquire. The AP would demand a return on these funds, and also would want to enter into stop-loss arrangements. This usually would require the taxpayer to give the AP the right to "put" the property to the taxpayer at a price that ensured the AP made a profit on its investment.

The put given to the AP avoided the AP's risk of loss but did not ensure that the taxpayer could acquire the replacement property if the property appreciated in value. As a result, the taxpayer frequently wanted a "call" option on the property. Most practitioners were concerned that simultaneous puts and calls could result in a transfer of all of the benefits and burdens of ownership of the property to the taxpayer. As a result, in most reverse exchanges the parties were given nonsimultaneous put and call rights, which created some economic risk for both the taxpayer and the AP.

Moreover, any contractual relationship between the taxpayer and the AP had to be structured so as to preserve the fiction that the AP was the owner of the property. This resulted in a requirement that leases and loans bear arm's-length rents and interest rates. Likewise, although most practitioners became comfortable with the taxpayer's guaranteeing the loan used by the AP to acquire the property, some type of guarantee fee usually had to be paid. The AP could not serve as the QI in connection with a transaction involving the property, because this might make the AP into the taxpayer's agent for

purposes of determining constructive receipt (even if a QI is not deemed to be a taxpayer's agent solely for the purpose of applying Section 1031 to forward exchanges). 18

All of these various conditions added to the risks (and the transaction costs) for reverse exchanges before Rev. Proc. 2000-37. The Procedure expressly eliminated all of these requirements. Specifically, property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's-length bargaining between unrelated parties with respect to such arrangements.

Acting as QI. An EAT that otherwise satisfies the requirements of Reg. 1.1031(k)-1(g)(4) (i.e., an EAT that is not a disqualified person with respect to the taxpayer) may enter into an exchange agreement with the taxpayer to serve as the QI in a simultaneous or deferred exchange of the property. This provision allows the numerous title companies and exchange accommodators that have been serving as QIs to provide one-stop shopping. The same person may serve as the EAT for the acquisition of the replacement property and the QI in the sale of the relinquished property.

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

What is the impact of the OID rules in Sections 1272 and 1273 on an interest-free loan? So long as the EAT is not related to the taxpayer (which would not be permitted in any event under Rev. Proc. 2000-37), no interest would be required under these provisions as long as the loan is for a period of less than one year. 19 Because the maximum term of a QEAA is only 180 days, there should be no imputed-interest problem in an interest-free loan made by a taxpayer to an EAT.

Loan guarantees. The taxpayer or a disqualified person may guarantee some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnify the EAT against costs

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and expenses. This addresses the practical problem that the EAT would not want to bear the risk of any environmental or tort liability. The ownership of the property by the EAT is a mere fiction, which is confirmed by this type of indemnification.

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

Management. The taxpayer or a disqualified person can manage the property, supervise improvement of the property, act as a contractor or otherwise provide services to the EAT with respect to the property.

Even though the EAT owns the property, as a practical matter the taxpayer is responsible for everything, including improvements to the property. This is particularly important in situations involving build-to-suit arrangements, in which the EAT is holding title to the replacement property while the taxpayer erects improvements on the property.

Puts and calls. The taxpayer and the EAT may enter into agreements and arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not more than 185 days from the date the property is acquired by the EAT. This allows both the EAT and the taxpayer to assure themselves that, at the end of the QEAA, the property will be transferred by the EAT to the taxpayer.

Although Rev. Proc. 2000-37 specifically provides that puts and calls will not adversely affect a QEAA and also refers to "agreements or arrangements relating to the purchase or sale of the property," it does not refer to a binding contract of the EAT to sell the property to the taxpayer on a specific date. Because the EAT is merely serving as an accommodation titleholder, there does not seem to be any reason why such a contract would violate the intent or purpose of Rev. Proc. 2000-37.

Nonetheless, it is possible that some taxpayers may shy away from such direct purchase and sale contracts, relying instead on puts and calls. This could be a problem, however, if either party (the taxpayer or the EAT) filed for bankruptcy. In that event, a put or call could be voided by a bankruptcy court in situations in which a contract still would provide certain legal rights. It is hoped the IRS will modify Rev. Proc. 2000-37 eventually to provide that a contract to purchase and sell the property, as well as puts and calls on the property, will not adversely affect a QEAA.

Make whole. In a swap-first transaction, the EAT acquires the relinquished property from the taxpayer and (at least theoretically) is subject to risk from any changes in the value of the relinquished property. To avoid this result, the QEAA may allow the taxpayer and the EAT to enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the EAT's receipt of the property be taken into account on the EAT's disposition of the relinquished property. This "make whole" provision can be accomplished through the taxpayer's advance of funds to, or receipt of funds from, the EAT.

Other tax treatment. Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the EAT is different from the federal income tax treatment. Thus, although the EAT must be treated as the owner of the property for federal income tax purposes, the EAT does not have to be treated as the owner of the property for any other purposes.

Reverse Exchanges-Remaining Questions

Although Rev. Proc. 2000-37 sets forth a safe harbor, several practical questions have arisen.

First, many practitioners are concerned about how "safe" is the safe harbor provided by the IRS. That is, if a taxpayer engages an EAT to assist in a reverse exchange, can the taxpayer:

(1) Provide all of the funds to the EAT through an interest-free loan?

(2) Use the property owned by the EAT without paying any rent?

(3) Require the EAT to undertake any actions with respect to the property that are viewed as convenient to the taxpayer?

(4) Otherwise disregard the fact that, for all local law purposes, the EAT would be treated as the agent of the taxpayer?

The answer appears to be that the safe harbor is absolutely safe: As long as the requirements of Rev. Proc. 2000-37 are complied with, the IRS will not challenge the treatment of the EAT as the owner of the property for federal income tax purposes. 20

State and local tax implications. Even though the federal income tax consequences of safe harbor reverse exchanges appear to be clear, the state and local consequences are much less certain.

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

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the taxpayer (in an swap-last transaction) or when the EAT acquires the relinquished property from the taxpayer (in a swap-first transaction). No authorities currently sanction the effectiveness of such a provision, however, and it is possible that the state and local tax agencies will attempt to impose transfer tax twice in such situations.

A related question concerns the state and local income taxation of these transactions. Rev. Proc. 2000-37 is only a safe harbor that prevents the IRS from challenging a taxpayer's treatment of a transaction-it is not a statement of substantive law. As a result, a state or local tax agency could possibly challenge the validity of a reverse like-kind exchange by simply ignoring Rev. Proc. 2000-37 and arguing that the EAT is the agent of the taxpayer (which it usually is), so that the acquisition of the replacement property by the EAT should be viewed as an acquisition of replacement property by the taxpayer. This argument would be particularly persuasive in those jurisdictions that do not automatically incorporate all of the federal tax law interpretations. Even a state that does "piggy back" federal law could ignore Rev. Proc. 2000-37 in establishing its own litigation policy with respect to reverse exchanges.

Noncompliant transactions. Another important practical issue concerns the likely treatment of a taxpayer who attempts to convert a safe harbor transaction into a transaction that does not comply with the safe harbor. Rev. Proc. 2000-37 clearly contemplates the possibility of a reverse exchange outside of its requirements. If, however, a taxpayer initially acquires replacement property through an EAT, and if

the taxpayer is unable to dispose of the relinquished property within the 180-day period provided in the safe harbor, can the taxpayer subsequently convert the transaction into a non-safe-harbor exchange?

It is currently unclear whether such conversions could be arranged. The IRS would likely argue that the EAT was the agent of the taxpayer in substance, so that if the safe harbor does not apply the acquisition of the replacement property by the EAT would be treated as an acquisition by the taxpayer, which would ruin the like-kind exchange.

Such an argument would be consistent with the Tax Court's decision in *DeCleene,* 115 TC 457 (2000), in which the court rejected a parking transaction that was not subject to the safe harbor. **21** Put simply, the Service is likely to argue that a transaction must be either wholly in or wholly outside of the safe harbor, and that a transaction cannot change from one side of the line to the other without adverse tax consequences.

Nevertheless, the taxpayer could argue that intent governs the application of Section 1031(a), and that the taxpayer's intent to engage in an exchange is not eliminated if the safe harbor is not satisfied. Suppose an EAT acquires replacement property for a taxpayer, but the taxpayer does not sell her relinquished property (and acquire the replacement property from the EAT) for 181 days. The safe harbor is not applicable because the 180-day requirement has been exceeded by one day, but that requirement is administrative, not statutory. The taxpayer would argue that her intent was always to engage in an exchange involving her relinquished property and that such an exchange occurred. Although the IRS could argue that the transaction is taxable because the EAT was the agent of the taxpayer, it is difficult to see how one day changes the nature of the underlying transaction. Thus, the taxpayer may be able to raise a strong argument that the transaction is not taxable, notwithstanding the taxpayer's failure to comply with Rev. Proc. 2000-37.

RELATED-PARTY INVOLVEMENT

Tax lawyers are taught early on that substance generally governs over form. One of the areas in which there are exceptions to the general rule involves like-kind exchanges under Section 1031, in which the form of the transaction is critical. The importance of form was emphasized in two recent rulings involving the acquisition of replacement property from a related party. One transaction was allowed, one was not. And it could be argued that the only real difference between the two transactions was their form.

The two pronouncements in question are Rev. Rul. 2002-83, 2002-2 CB 927, and Ltr. Rul. 200251008. In both transactions, the taxpayer desired to acquire replacement property from a related party. In Rev. Rul. 2002-83, the taxpayer attempted to acquire the property from a QI who purchased the property from the related party; this was not allowed under the anti-abuse rule in Section 1031(f)(4). In Ltr. Rul. 200251008, in contrast, the related party first transferred its property to an EAT in connection with a reverse exchange; the EAT obtained the money needed to develop the replacement property through a loan from the taxpayer. When the EAT subsequently sold the replacement property to the taxpayer, the

IRS concluded that the transaction was permissible.

Background-Related-Party Exchanges

As noted above, Section 1031(f) provides special rules for exchanges between related parties. Under Section 1031(f)(1), a taxpayer exchanging like-kind property with a related person cannot qualify for nonrecognition under Section 1031(a)(1) if, within two years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. For purposes of this provision, related parties are defined using the rules in Sections 267(b) and 707(b).

This provision is intended to deny nonrecognition treatment for transactions

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in which related parties make like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. The legislative history underlying Section 1031(f) states that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment and the original exchange should not be accorded nonrecognition treatment. **22**

Example: Tom and Anne are related. Tom owns Blackacre with a basis of $100 and an FMV of $1,000. Anne owns Whiteacre with a basis and FMV of $1,000. Tom wants to sell Blackacre to Jerry for $1,000. Prior to the enactment of Section 1031(f)(1), Tom and Anne could have reduced their overall tax liability as follows: (1) Tom and Anne trade Blackacre for Whiteacre, then (2) Anne exchanges Blackacre for $1,000 cash from Jerry. Because Anne would have had a $1,000 basis in Blackacre under Section 1031(d), she would not have recognized gain on the sale. As a result of Section 1031(f)(1), the original exchange between Tom and Anne would be taxable unless each retained the property received in the exchange (Whiteacre and Blackacre, respectively) for at least two years.

To prevent taxpayers from circumventing the general rule in Section 1031(f)(1), Congress also enacted Section 1031(f)(4), which provides that Section 1031(a)(1) does not apply to any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of Section 1031(f)(1). The legislative history contains the following description of a transaction under Section 1031(f)(4): If a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under Section 1031, the related party will not be entitled to nonrecognition treatment under Section 1031. **23**

Congress also recognized, however, that not all related-party exchanges would be abusive. Accordingly, Section 1031(f)(2) provides that for purposes of applying the two-year rule in Section 1031(f)(1), dispositions in the following circumstances will not be taken into account:

- After the earlier of the death of the taxpayer or the death of the related person.
- In a compulsory or involuntary conversion if the exchange occurred before the imminence or threat of such event.
- With respect to which it is established to the satisfaction of the IRS that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax.

The legislative history of Section 1031(f)(2) notes that it is intended that the non-tax-avoidance exception generally will apply to (1) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties, (2) dispositions of property in nonrecognition transactions, and (3) transactions that do not involve the shifting of basis between properties. The last exception is somewhat confusing, because under Section 1031(d) basis is always shifted in a like-kind exchange; presumably a distinction should be drawn between an abusive basis shift which avoids gain recognition and a basis shift that does not avoid gain recognition among the related parties.

The Revenue Ruling

In Rev. Rul. 2002-83, individual A owned real estate (property 1) with an FMV of $150 and an adjusted basis of $50. Individual B owned realty (property 2) with an FMV of $150 and an adjusted basis of $150. Both properties were held for investment, and A and B were related persons within the meaning of Section 267(b).

C, an unrelated person, desired to acquire property 1 from A. A entered into an agreement for the transfers of property 1 and property 2 with B, C, and a QI that was unrelated to any of the parties. Pursuant to their agreement, A transferred property 1 to the QI and the QI then transferred property 1 to C for $150. Several days later, the QI acquired property 2 from B for $150 cash, and transferred property 2 to A in order to complete the exchange for property 1. Thus, the facts in Rev. Rul. 2002-83 are essentially the same as set forth above in the example involving Tom, Anne, and Jerry.

The IRS concluded that A was using the QI to circumvent the purposes of Section 1031(f) in the same way that the unrelated party was used to circumvent the purposes of Section 1031(f) in the example in the legislative history of Section 1031(f)(4) quoted above. Absent Section 1031(f)(1), A and B could have engaged in a direct like-kind exchange of property 1 for property 2, and B then could have sold property 1 to C. This "direct" way to accomplish the transaction was barred by Section 1031(f)(1), so instead A used a transfer of property 1 to the QI in an attempt to obtain the same result without gain recognition. This series of transactions allowed A to try to cash out of property 1 without gain recognition.

Accordingly, Rev. Rul. 2002-83 concluded that A's exchange of property with the QI was part of a transaction structured to avoid the purposes of Section 1031(f) and, under Section 1031(f)(4), the nonrecognition provisions of Section 1031(a) did not apply to the exchange between A and the QI. A's exchange of property 1 for property 2 was a taxable transaction in which A recognized gain of $100.

The results and reasoning in Rev. Rul. 2002-83 were not surprising. What was somewhat surprising, however, was the Service's failure to even mention Section 1031(f)(2) in the Ruling or otherwise consider that there could be extenuating circumstances in which the acquisition of replacement property from a related party is not abusive.

For instance, if the related party had a significant gain inherent in the replacement property, it is not clear why nonrecognition treatment should be denied to the taxpayer. Nonrecognition also should be available if the replacement property were inventory in the hands of the related party, because the gain inherent in such inventory would be recognized.

Finally, what if the related party had a loss inherent in the replacement property? Presumably, that loss would be deferred under Section 267(b). In that event, no apparent policy reason would require gain recognition on the sale of the relinquished property and disallow the loss on the sale of the replacement property.

The foregoing notwithstanding, the result reached by the Service in Rev. Rul. 2002-83 reinforced what most tax advisors long had been telling their clients-do not acquire replacement property from a related party. The Service had adopted that position in two private rulings, so that published guidance on the point was not unexpected. Now, all taxpayers have been formally warned that an acquisition of replacement property from a related party in a transaction utilizing a QI will be subject to Section 1031(f)(4).

The Letter Ruling

In Ltr. Rul. 200251008, the taxpayer owned property that was under contract to be sold to a third party (relinquished property) and a related party had a long-term leasehold interest in other property. The taxpayer desired to obtain, as replacement property for its relinquished property, a leasehold position in the replacement property for a term in excess of 30 years. **24** The taxpayer also wanted to improve the replacement property using the proceeds from the sale of the relinquished property, and it would take some time to make those improvements.

To accomplish this transaction, the taxpayer first caused the related party to convey a leasehold position in the replacement property to an SMLLC owned by an EAT pursuant to a QEAA. The taxpayer then guaranteed a loan to the SMLLC; that loan permitted the EAT to construct improvements on the replacement property according to the taxpayer's plans and specifications.

At the earlier of the completion of the improvements or 180 days, the following occurred:

(1) The taxpayer sold the relinquished property to the third-party purchaser through a QI.
(2) The proceeds from the sale of the relinquished property were used to acquire the SMLLC (which owned the leasehold interest in the replacement property) from the EAT.

(3) The QI transferred the leasehold interest in the replacement property to the taxpayer in order to complete the exchange for the relinquished property.

(4) The EAT used the money that it had received for the replacement property to pay back the loan.

Thus, when the dust settled, the taxpayer owned a long-term leasehold interest in the replacement property (fee title to which was owned by a person related to the taxpayer), and the replacement property had been improved using the proceeds from the sale of the relinquished property.

The Service concluded that this was a parking transaction between related parties but that it also satisfied all of the requirements of Rev. Proc. 2000-37. Under the safe harbor, the IRS will not challenge either (1) the qualification of property held by the EAT as replacement property or relinquished property or (2) the treatment of the EAT as the beneficial owner of property held in a QEAA. Because the replacement property was held by the EAT, the taxpayer had to be treated as acquiring the leasehold interest in the replacement property from the EAT (and not from the related person who previously owned such interest). Therefore, the taxpayer had engaged in a "good" exchange with the EAT, even though the EAT never had any economic interest in the replacement property. **25**

Although the conclusions in Ltr. Rul. 200251008 follow directly from Rev. Proc. 2000-37, the result was nonetheless quite surprising. As a practical matter, the letter ruling allows a taxpayer to acquire replacement property from a related party as long as the property is first parked with an EAT. This result was unexpected in light of Rev. Rul. 2002-83, which expressly forbids the acquisition of replacement property from a related party. But the conclusion also is consistent with Rev. Proc. 2000-37, under which the IRS agreed not to ignore or look through ownership of property by an EAT.

The conclusions in the letter ruling also could be defended on the grounds that the related party owned only a leasehold interest in the replacement property, as there was no "sale" by the related party of its interest. Finally, the ruling notes that all money received on the sale of the relinquished property was reinvested in the replacement property, which supports nonrecognition of gain.

Example: Suppose individual B in Rev. Rul. 2002-83 had first conveyed property 2 to an EAT, and individual A (the taxpayer) had loaned the EAT the $150 needed to acquire property 2. A then sold property 1 to C for $150 and acquired

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property 2 from the EAT as replacement property. The EAT used the proceeds from the sale to repay the loan to A. When the transaction is completed, A has engaged in a like-kind exchange for property 1, B has sold property 2, and C has purchased property 1 for $150 in cash. That is exactly the same outcome as occurred in Rev. Rul. 2002-83, except that an argument could be made that the insertion of an EAT alters the tax consequences. It is unclear whether the IRS would agree.

From a planning perspective, Ltr. Rul. 200251008 highlights the importance of the safe harbor under Rev. Proc. 2000-37. It also highlights the potential importance of "form" in Section 1031. By using a

reverse exchange, a taxpayer may be able to accomplish indirectly what could not be done directly, i.e., the acquisition of improved replacement property from a related person. The conclusion in the letter ruling seems to be technically correct on its facts, so unless a substance-over-form rule were overlaid on the transaction, the result follows the literal terms of Section 1031 and Rev. Proc. 2000-37. The IRS, however, is likely to contend that the letter ruling should be limited to its facts and applies only to the taxpayer who received it.

LEVERAGE ISSUES

The requirements of the nonrecognition rules result in different issues with respect to leveraging, depending on whether it is the replacement property being encumbered after the exchange or the relinquished property being encumbered before the exchange.

Leverage After an Exchange

A practical question that continues to arise in like-kind exchange transactions is whether the taxpayer can encumber the replacement property after the exchange and, if so, when. This leverage effectively allows the taxpayer to withdraw any equity inherent in the replacement property. Four years ago there was no definitive answer to this question, although your author then stated that there was no reason why a taxpayer could not encumber replacement property after an exchange. Indeed, your author subscribed to the theory under which a taxpayer can leverage the replacement property one nanosecond after it is acquired. Your author's views on this issue remain unchanged. Several practical points need to be considered, however.

First, if a taxpayer intends to leverage replacement property immediately after an exchange, the taxpayer should make certain that the debt is not incurred until *after* the exchange. As a practical matter, this means that the debt financing should be evidenced by a separate closing with a separate settlement statement from the title company. Although the acquisition and the financing can occur in back-to-back transactions, the two transactions should be distinct and separate, and title to the replacement property should be clearly vested in the taxpayer before debt is placed on the property.

In addition, although a taxpayer is free to leverage property after an exchange, a different tax result could occur if the taxpayer lacks the ability to decline to borrow against the replacement property. This issue arises most frequently in "pay down, borrow back" transactions, in which the taxpayer has sold a relinquished property with significant equity and the replacement property was previously leveraged. If the amount of the debt encumbering the replacement property is not reduced, the taxpayer will not be able to invest all of the exchange proceeds in the replacement property, resulting in taxable gain.

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To deal with this problem, sometimes the seller of the relinquished property will pay down the debt

immediately before the exchange, with the understanding that the taxpayer will borrow back from the same lender immediately after the exchange. A pay down, borrow back transaction is permissible if the taxpayer is not economically forced to re-leverage the replacement property. If, however, the lender whose debt is paid down by the seller of the relinquished property would impose a significant economic penalty on the taxpayer for failing to re-leverage the property, the issue becomes whether, in substance, the debt was ever paid down at all. Indeed, in such situations the IRS could take the position that the taxpayer only invested the net amount (reduced by the debt) in the replacement property, which could result in significant gain being recognized. To avoid this potential issue, it usually is recommended that the amount payable to the lender if the taxpayer fails to re-leverage the replacement property should not exceed the amount of a customary loan commitment fee. **26**

Leverage Before an Exchange

A more difficult question is whether the taxpayer can encumber the relinquished property immediately before a like-kind exchange. This leverage permits the taxpayer to withdraw equity from the property and also allows the taxpayer to acquire a replacement property that is subject to the same or greater leverage. Four years ago there was no definitive guidance on this issue, and there is still none. The limited authorities indicate that such transactions are risky, particularly if the relinquished property is encumbered immediately before the exchange.

The IRS has indicated that it may take the position that encumbering a property immediately before an exchange could result in boot to the taxpayer. In Ltr. Rul. 8434015, the Service concluded that the effect of encumbering property before an exchange was to permit the taxpayer to cash out of the property without incurring the corresponding tax for money received under Section 1031. The IRS argued that the netting rules should not be literally applied to achieve this result. In reaching this conclusion, the Service argued that *Garcia,* 80 TC 491 (1982), which permitted liability netting, could be distinguished because it involved an assumption of a debt with independent economic significance.

The logic underlying Ltr. Rul. 8434015 is questionable. As noted above, it is well established that a taxpayer can encumber property without tax consequences. Furthermore, if property is encumbered and then transferred as part of a like-kind exchange, the Regulations are clear that the transferor will recognize gain unless an equal or greater amount of debt encumbers the replacement property received in the exchange. Thus, from a before-and-after perspective the taxpayer's liabilities will not be reduced as a result of a like-kind exchange. **27**

Moreover, analytical support for the conclusion that no gain is recognized merely because property is encumbered before a like-kind exchange can be found in the Regulations under Section 707(a)(2)(B), relating to disguised sales between partners and partnerships. In general, Section 707(a)(2)(B) requires a taxpayer to recognize gain or loss if (1) property is transferred to a partnership, (2) the transferor receives a distribution of money or other property from the partnership, and (3) the effect of the transaction is a sale.

The Section 707(a)(2)(B) Regulations recognize that the economic equivalent of a sale could be obtained if a taxpayer encumbers property a short time before the property is transferred to the partnership. Accordingly, the Regulations provide that if property is transferred to a partnership subject to a nonqualified liability, 28 or if the nonqualified liability is assumed by the partnership, the transaction is treated as a cash distribution to the transferor to the extent that the transferor's share of the liability is reduced.

For purposes of our discussion, the important aspect of the partnership rule is that there are no tax consequences under Section 707(a)(2)(B) if and to the extent that the transferor's share of the liability is not reduced. Thus, if Harry encumbers Greenacre with $1 million of debt immediately before transferring Greenacre to a partnership, Harry will have no tax consequences as long as he is allocated at least $1 million of the partnership's debt after the transfer.

Logically, the same result should apply in Section 1031 exchanges. Thus, a taxpayer should be able to encumber the relinquished property immediately before a like-kind exchange *if* the replacement property received in the exchange is encumbered by an equal or greater liability. In that situation, although the taxpayer has "monetized" her property, she has done so by increasing her debt, which is not a taxable event.

ENTITIES OWNED BY SPOUSES

Four years ago, a hot issue was whether a taxpayer living in a community property state could use a disregarded entity to acquire replacement property. In Rev. Proc. 2002-69, 2002-2 CB 831, the IRS provided guidance regarding the classification of an entity owned solely by a husband and wife as community property. The Procedure defines both the entities it governs and explains how these entities will be

classified for federal income tax purposes.

According to Rev. Proc. 2002-69, an entity is a "qualified entity" to which it applies if (1) the entity is wholly owned by a husband and wife as community property under the laws of a state, foreign country, or U.S. possession, (2) no person other than one or both spouses would be considered an owner for federal tax purposes, and (3) the entity is not treated as a corporation pursuant to Reg. 301.7701-2(b).

The Service will treat a "qualified entity" as a disregarded entity for federal tax purposes if the qualified entity and the husband and wife as community property owners treat the entity as a disregarded entity for federal tax purposes. The IRS will treat a qualified entity as a partnership, however, if the qualified entity and the husband and wife as community property owners treat the entity as a partnership and file the appropriate partnership returns.

Although not defined in Rev. Proc. 2002-69, "community property" generally means property owned in common by a husband and wife, each having an undivided one-half interest by reason of their marital status. Nine states have community property systems that may qualify under Rev. Proc. 2002-69: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (with adoption of the Uniform Marital Property Act). All other states are classified as common law jurisdictions. The Revenue Procedure does not address the treatment of entities owned by married co-owners in common law property states.

TENANCY-IN-COMMON ARRANGEMENTS

One of the hottest issues concerning like-kind exchanges four years ago involved whether a tenancy-in-common (TIC) interest would be treated as an interest in real estate or as a partnership interest for Section 1031 purposes. Under the former approach, a taxpayer could acquire a TIC interest as replacement property for other real estate; under the latter view, the TIC interest would not be acceptable replacement property under Section 1031(a)(2)(D).

There was a well-established body of law in this area, but the Service's position was not clear until recently. At the heart of the legal analysis are several cases, including the Supreme Court's decision in *Culbertson,* 37 AFTR 1391 337 US 733 93 L Ed 1659 (1949). There, the Court stated that whether a partnership is created depends on whether the alleged partners really and truly intended to join together for the purpose of carrying on business and sharing the profits or losses or both. This determination is a question of fact, to be determined by the partners' testimony, their agreement and their conduct. Subsequent decisions, such as *Luna,* 42 TC 1067 (1964), set forth specific factors to be considered in determining whether an arrangement should be treated as a partnership for tax purposes.

Prior to 2000, the IRS had considered the treatment of TIC interests in Rev. Rul. 75-374, 1975-2 CB 261, which concluded that a two-person co-ownership of an apartment building rented to tenants was not a federal tax partnership. In that Ruling, the co-owners employed an agent to manage the apartments on their behalf. The agent collected rents; paid property taxes, insurance premiums, and repair and maintenance expenses; and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The Ruling concluded that the agent's activities were not sufficiently extensive to cause the co-ownership to be characterized as a partnership for federal income tax purposes. **29**

In contrast to Rev. Rul. 75-374 were several court decisions in which a co-ownership arrangement was found to be a tax partnership. For example, in *Bergford,* 73 AFTR 2d 94-498 12 F3d 166 94-1 USTC ¶50004 (CA-9, 1993), 78 investors purchased "co-ownership" interests in computer equipment that was subject to a seven-year net lease. The investors authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the investors to decide by majority vote whether to sell or

lease the equipment at the end of the initial lease term; absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10% of the equipment's selling price or lease rental whether or not an investor terminated the agreement or the manager performed any remarketing. An investor could assign her interest in the property only after fulfilling numerous conditions and obtaining the manager's consent.

The *Bergford* court held that the co-ownership arrangement was a partnership for tax purposes. **30** In reaching this conclusion, the court emphasized the limitations on each investor's ability to sell, lease, or encumber either her interest or the underlying property, as well as the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Two other courts reached similar conclusions where a promoter/manager maintained a significant economic interest in the property that was sold to co-owning investors. **31**

In one other important decision, *Madison Gas & Electric Company,* 46 AFTR 2d 80-5955 633 F2d 512 80-2 USTC ¶9754 (CA-7,

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1980), *aff'g* 72 TC 521 (1979), the court held that a co-generation operation conducted by three utilities as tenants in common was a partnership for tax purposes because the parties shared expenses and divided the jointly produced property among themselves.

The legal uncertainty was exacerbated in situations involving TIC interests. Various real estate companies discovered that taxpayers who had sold relinquished property wanted to acquire replacement property with high-quality tenants, but the high cost of such properties often made the transactions unaffordable except for very wealthy individuals and large corporations. If, however, a taxpayer could acquire a partial interest in an attractive building, the taxpayer might be able to acquire a higher-quality property than he otherwise could afford. The various owners of the property (the co-owners) would then enter into a TIC agreement that set forth their legal relationship without entering into a partnership that involves the sharing of profit or loss.

EXAMPLE: John and Brian, two unrelated taxpayers, each sold a relinquished property for $1 million. A new store that was leased to a tenant with a solid credit rating cost $2 million; neither John nor Brian could afford to acquire the store on his own. If, however, John and Brian could combine their funds they could acquire the building as co-tenants. The difficult problem was for John and Brian to find each other; an industry has developed to acquire properties and sell them to buyers such as John and Brian.

The IRS initially was not certain whether it wanted to treat these types of arrangements for tax purposes as ownership through a tenancy in common or as a partnership. This indecision was reflected in Rev. Proc. 2000-46, 2000-2 CB 438, in which the IRS announced that it would not issue rulings on this question. The Service also sought comments from concerned parties about the issue. The IRS received significant comments, all of which suggested that a properly structured TIC arrangement should not be treated as a partnership for tax purposes.

The IRS then issued Rev. Proc. 2002-22, which set forth new ruling guidelines for purposes of determining whether a TIC arrangement involving rental real estate which is treated as a tenancy in common for local law purposes would be treated as the ownership of real estate or a partnership for tax purposes. The Procedure states that these guidelines are solely to assist taxpayers in preparing ruling requests, and the IRS in issuing rulings, and that they are not intended to be substantive rules or used for audit purposes. The Service ordinarily will not consider a request for a ruling if the conditions provided in Rev. Proc. 2002-22 are not satisfied, although even if such conditions are all met the IRS still may decline to issue a ruling whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

The Service's disavowal to the contrary notwithstanding, as a practical matter the guidelines in Rev. Proc. 2002-22 have effectively become a safe harbor for structuring TIC interests that can be acquired as replacement property in like-kind exchanges. Tax practitioners are comfortable issuing a favorable opinion to taxpayers with respect to TIC interests that satisfy the requirements of the guidelines, whereas practitioners will be less comfortable issuing favorable opinions if the TIC interests are not described in these guidelines.

A detailed discussion of all of the requirements in Rev. Proc. 2002-22 is beyond the scope of this article. [32] Practitioners, however, are rapidly becoming comfortable that several of the requirements in Rev. Proc. 2002-22 are "essential elements" of a TIC arrangement, whereas some other requirements are not as critical or can be modified to a certain degree. The practical result of these conclusions is that real estate companies are obtaining favorable opinions from counsel for TIC transactions that satisfy the most essential elements of Rev. Proc. 2002-22 but that may contain variations on minor points.

Rev. Proc. 2002-22-Important Elements

The first of the conditions for obtaining a ruling under Rev. Proc. 2002-22 is set forth in section 6.01, which provides that "[e]ach of the co-owners must hold title to the [p]roperty (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the [p]roperty as a whole may not be held by an entity recognized under local law." This seemingly innocuous statement has two key components.

First, by rejecting any ruling requests if title to the property is held by an entity, the IRS is stating that it will not view favorably attempts by taxpayers to elect out of partnership status under Section 761. That is, even if all of the requirements of Reg. 1.761-2(a)(2) are satisfied, the mere ownership of title by a legal entity is sufficient to prevent a ruling that a partnership is not present. Some promoters have attempted to sell TIC interests where title to the property is held by a legal entity such as a Delaware business trust or a grantor trust; Rev. Proc. 2002-22 specifically rejects this approach.

Nevertheless, Rev. Proc. 2002-22 specifically endorses the use of disregarded entities to hold title to the TIC interests. This provision is critical because, as a practical matter, each of the co-owners frequently

will be required by the other co-owners (or the sponsor) to place his or her TIC interest into a disregarded entity (usually an SMLLC) in order to avoid legal risks arising from the death or bankruptcy of a co-owner. If a TIC interest is held by an SMLLC, the death or bankruptcy of the owner of the SMLLC will not directly

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affect the other owners of interests in the property. **33** In contrast, if the TIC interests were owned directly, each of the co-owners could find its economic position subject to judicial control as a result of the death or bankruptcy of a co-owner of the property. Thus, section 6.01 provides an important endorsement for the holding of TIC interests through SMLLCs, which is an essential aspect of any well-constructed ownership structure.

Avoid the appearance of a partnership. Another important requirement is that the owners of the real property not hold themselves out as engaged in a joint venture or partnership. According to section 6.03 of the Procedure, the co-ownership may not do any of the following:

- File a partnership or corporate tax return.
- Conduct business under a common name.
- Execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity.
- Otherwise hold itself out as a partnership or other form of business entity.

Similarly, the co-owners may not hold themselves out as partners, shareholders, or members of a business entity. In addition, the co-owners generally cannot have held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership. **34**

Approval rights. The owners of the TIC interests must also retain approval rights over the most important issues affecting their property. According to section 6.05 of the Procedure, the co-owners must retain the right to approve the following:

- The hiring of any manager.
- The sale or other disposition of the property.
- Any leases of a portion or all of the property.
- The creation or modification of a blanket lien.

Any sale, lease, or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners.

For all other actions, the co-owners may agree to be bound by the vote of those holding more than 50% of the undivided interests in the property. A co-owner who has consented to an action may provide the property manager or some other person a power of attorney to execute specific documents with respect to that action, but not a global power of attorney.

Although these requirements for TIC approval seem somewhat onerous, a practical approach has been approved by the IRS. Specifically, most TIC agreements now contain an "implied consent" provision under which each of the co-owners is provided notice of an event (a sale, lease, financing or re-appointment of the property manager), and each co-owner is then given a specified period of time to object (usually 72 hours for a lease, and much longer for a sale, financing, or reappointment of the property manager). If none of the co-owners object to the proposed action, it is deemed to have been approved. **35** This type of "implied consent" was approved by the IRS in an as-yet unnumbered letter ruling issued 3/7/03.

A related result of these approval requirements is that TIC arrangements currently take one of two forms.

> (1) Some TIC arrangements involve a long-term triple-net master lease of the property to a tenant (often related to the sponsor or promoter of the arrangement); the master lessee subleases the property to the tenants who are its actual users. This type of arrangement obviates the need for the co-owners to approve leases for the property, because the co-owners have approved the master lease but are not required to approve each sublease for the property. Because the rent paid to the co-owners must be either a flat rent or based on gross receipts, the master lessee can make a significant profit from the spread between the rent paid to the co-owners and the rent received from the actual tenants in the property. (If the property is not performing optimally, however, the co-owners can expect to receive fixed rent from the master lessee, who will bear any loss resulting from insufficient rent from the sub-lessees.)
>
> (2) To minimize this potential "leakage" for the benefit of the master lessee, other TIC sponsors prefer to structure transactions in which rent is paid by the tenants to the co-owners, and a property manager is hired to operate the property. The advantage of this structure is the absence of a master lease; the disadvantage is that co-owner consents must be obtained for each new lease and the property management agreement must be renewed at least annually. **36**

Thus, there is a trade-off between simplicity and potential economic returns, and respectable sponsors have structured transactions both ways.

An open question is whether the co-owners can delegate authority to the property manager to approve leases that follow an approved form and guidelines. The difficulty of obtaining approval of each lease would be mitigated if the co-owners could annually approve the form of lease and rental guidelines, with the property manager being permitted to enter into a lease that conforms to both without seeking approval from the co-owners. Although this would be a practical approach that should not adversely affect the tax treatment of a TIC, as of now it has not been approved by the IRS. A favorable ruling probably would be

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needed to implement this type of TIC arrangement.

Restrictions on alienation. Another important aspect of each TIC arrangement involves restrictions on alienation. In general, each co-owner must have the right to transfer, partition, and encumber the co-owner's TIC interest in the property without the agreement or approval of any person. [37] Nevertheless, restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited.

Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (i.e., the right to have the first opportunity to offer to purchase the TIC interest). In addition, a co-owner may agree to offer its TIC interest for sale to the other co-owners, the sponsor or the lessee at FMV before exercising any right of partition, with the FMV to be determined as of the time the partition right is exercised.

Distributions and sharing. Under section 6.07 of Rev. Proc. 2002-22, if the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners. This provision prevents the retention of profit or debt by one of the co-owners on the sale of the property, which would be indicative of a partnership (through the non-pro-rata sharing of profits and liabilities).

Each co-owner also must share in all revenue generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property, under section 6.08.

In addition, "[n]either the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days."

The requirement that all profits and costs related to the property be shared pro rata was to be expected; non-pro-rata sharing of the costs or benefits of operation of the property would be evidence of a partnership arrangement. More unusual, however, is the requirement that one co-owner cannot advance funds for the benefit of another for any period in excess of 31 days. Thus, for example, if there is an operating cash-flow shortfall, one co-owner can cover the shortfall for only a limited period. On the expiration of this 31-day period, either all co-owners would have to contribute their pro-rata share of the cash needs of the property or, in the alternative, the property (or the TIC interests of the defaulting co-owners) would presumably have to be sold.

The parenthetical clause in section 6.08 of Rev. Proc. 2002-22, quoted above, has become one of the most controversial aspects of this guidance. This provision would mandate that the individuals who own the interests in the SMLLC that actually holds the TIC interest would be personally liable to contribute cash to the SMLLC in the event that any other co-owner made an advance to cover operating deficits. As a practical matter, the effect of this provision would be to convert potentially nonrecourse liabilities into recourse obligations.

Moreover, most lenders require that the SMLLC be a "bankruptcy remote" entity, so that the SMLLC is

not obligated for the debts of its owner, and vice versa. The individual liability imposed by this parenthetical in section 6.08 would be contrary to the covenants required in most loan documents, so that a choice would need to be made between compliance with Rev. Proc. 2002-22 or compliance with the loan covenants. **38**

It also is difficult to understand why the Service feels that personal liability for such obligations provides less indicia of a partnership. While it was true under the Kintner Regulations that unlimited liability was a partnership factor, the advent of the LLC and the check-the-box Regulations indicate that unlimited liability may be more of a historic factor. The better view is that such a restriction in today's environment is not needed and is inconsistent with business (i.e., non-tax) motives. Most taxpayers have complied with their lenders' requirements, so that this parenthetical is ignored in most transactions in which there is debt financing. **39**

Other elements. Several other aspects of Rev. Proc. 2002-22 have been reflected in most transactions. First, section 6.09 provides that the co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests; this requirement is generally viewed as essential. Likewise, the co-owners cannot have the right to put their interests to any other person, including the sponsor, the lessee or any other co-owner. A co-owner may grant a call option to any other person, however, provided that the purchase price under the call option reflects the FMV of the property.

This latter rule has become an important practical element of most TIC arrangements. As noted previously, unanimous consent is required for most important actions involving the property, including sale, leasing, financing, and appointment of the property manager. In order to avoid the possibility that one co-owner can prevent the other co-owners from undertaking necessary or appropriate actions, each of the co-owners is usually required to grant a call option and a limited power of attorney that provides that if a specified percentage of the co-owners agree to an action, the dissenting co-owners will have to sell their interests to the consenting co-owners for FMV.

EXAMPLE: Individuals A through L own equal TIC interests in Blackacre. Bigco offers to purchase Blackacre for $1 million, and A through K (but not L)

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desire to accept the offer. A through K cannot force L to accept the offer, but in order to complete the transaction, A through K (or any subset thereof, or the property manager) could exercise their rights under the call option and acquire L's interest for its FMV. All of the co-owners could then sell Blackacre to Bigco for $1 million.

There are numerous other requirements in Rev. Proc. 2002-22 that are routinely satisfied in most TIC arrangements, including the rules involving the level of business activity, management and brokerage agreements, leasing agreements, lending arrangements and payments to the sponsor. **40** One of the few requirements that has been somewhat problematical is the rule that the property manager cannot be a lessee in the property; this prohibition would prevent the property manager from having an on-site

office in the property. This requirement seems particularly absurd if the property manager is not the sponsor (or a related party) and is paying arm's-length rent for the space it uses to manage the property. Again, counsel generally have become comfortable that this requirement can be ignored if an unrelated property manager is paying an arm's-length rent for the space it uses in the property.

In summary, Rev. Proc. 2002-22 provides a set of rules that are practical in most situations and that most sponsors and co-owners are able to substantially comply with. The effect of this guidance has been to "regularize" an industry that, prior to the issuance of the guidance, operated without any rules. The praise IRS received when it issued Rev. Proc. 2002-22 can be expected to continue if the Service demonstrates flexibility in rulings on the open issues discussed above.

LIKE-KIND EXCHANGES BY PARTNERSHIPS

The most frequently encountered problem in like-kind exchanges may involve the treatment of partnerships that own the relinquished property. **41** It is exceedingly common when a partnership sells its property that one or more of the partners want to "cash out" in the transaction, whereas other partners want to reinvest through a like-kind exchange. **42**

EXAMPLE: Jack, Karen, Luke, and Mary are equal partners in partnership JKLM, the only asset of which is Whiteacre, a rental apartment building worth $10 million. Jack inherited his interest from his recently deceased parent, and Karen contributed $2.5 million to JKLM (which the partnership used for capital improvements) for her interest, so they each have a stepped-up basis in their partnership interests. Luke and Mary have a zero basis in their interests. JKLM made a Section 754 election, so the partnership has a $5 million basis in Whiteacre.

A buyer has offered to purchase Whiteacre for its FMV of $10 million, and all of the partners want to sell. Jack and Karen want to cash out with their share of the proceeds of the sale, but Luke and Mary want JKLM to purchase replacement property so as to defer gain recognition.

If JKLM sells Whiteacre to the buyer and half of the proceeds are given to a QI and half are received by JKLM in cash (for distribution to Jack and Karen), the partnership will recognize $5 million of gain on the transaction, because gain is recognized to the extent of the boot received ($5 million in cash). If this gain were allocated equally to all of the partners, Luke and Mary would each recognize $1.25 million of gain but receive none of the cash; needless to say, this result would not be acceptable. There are at least three alternatives for resolving this situation.

Special allocations. Some partnerships have used a special allocation of the gain to the partners who cash out, i.e., the $5 million gain would be allocated to Jack and Karen. This gain would increase their basis in their partnership interests, so Jack and Karen also would have offsetting capital losses on the receipt of $2.5 million each from JKLM in redemption of their interests. (Of course, if any of the gain reflects depreciation recapture, Jack and Karen would have ordinary income and capital losses, which would not offset, resulting in adverse tax consequences.)

The problem with this approach is that it is not clear such special allocations have substantial economic effect. In this example, the gain allocation to Karen would increase her capital account to $5 million, but she would receive only $2.5 million from JKLM. Although the capital gain would be offset by a capital loss, resulting in no net tax liability to Karen, it is difficult to theoretically justify this special allocation under Section 704(b).

The allocation of gain to Jack does not raise this issue if he has a zero capital account, although the offsetting gain and loss are also somewhat troubling. Furthermore, the presence of depreciation recapture will scuttle this approach long before it reaches the launching pad, due to the partners' inability to offset ordinary income with capital losses.

Distribution of undivided interests. Assuming that the gain cannot be specially allocated to the cash-out partners, many partnerships have distributed undivided TIC interests in the property to their partners immediately before the sale. In our example, JKLM would distribute a 25% undivided interest in Whiteacre to Jack and Karen in redemption of their interests immediately before the sale, while Luke and Mary remain partners in the partnership. Alternatively, undivided interests could be distributed to all of the partners in liquidation of the partnership immediately before the sale to the buyer. Two issues arise:

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(1) Do the partners satisfy Section 1031's "held for use in a trade or business or for investment" test if they receive their undivided interests immediately before the sale?

(2) Notwithstanding the dissolution of JKLM, does the relationship between the partners constitute a deemed partnership under Section 761, particularly if there is a significant level of activity involved in the operation and management of Whiteacre? And if the level of activity is minimized by reducing the amount of time that the property is held by the (former) partners as tenants in common, does that undercut their position with respect to the first issue?

No authorities clearly confront these questions. With respect to the first issue, if Luke and Mary keep the partnership alive, there seems to be no question that the JKLM partnership satisfies the "held for" test. Even if JKLM is liquidated immediately before the sale, however, several analogous authorities indicate that the "held for" standard would be satisfied. The issues are discussed in detail below in connection with the tax treatment of "drop and swap" transactions.

In *Magneson,* 55 AFTR 2d 85-911 753 F2d 1490 85-1 USTC ¶9205 (CA-9, 1985), *aff'g* 81 TC 767 (1983), a taxpayer exchanged investment property for other like-kind property, and immediately thereafter contributed the replacement property to a partnership in exchange for a 10% general partnership interest. The court concluded that holding the property for contribution to the partnership was holding it for investment, and that the ownership of property as a general partner was not substantially different than direct ownership of the property. Similarly, in *Bolker,* 56 AFTR 2d 85-5121 760 F2d 1039 85-1 USTC ¶9400 (CA-9, 1985), *aff'g* 81 TC 782 (1983), the court permitted a like-kind exchange by a shareholder of a corporation who received the relinquished property immediately before the exchange through a nontaxable liquidation of the corporation. **43**

The problem is that these authorities are not completely on point, particularly because only rarely will the partners (or more commonly now, the members of a LLC) be general partners in a partnership. Furthermore, *Magneson* was decided when a tax-free exchange of partnership interests was permissible under Section 1031; Section 1031(a)(2)(D) altered that rule. Thus, there is at least some room for doubt that the "held for" requirement has been met if the partnership is liquidated.

The second issue also is a puzzling one. Logically, the distribution of undivided interests in the property should not result in a continuation of a partnership, but the broad definition of an "entity" could pick up co-ownership of actively managed property. In some situations, this risk has been minimized by net-leasing the property to a master lessee, **44** but this planning step is not always available. If such a net lease is not used, the determination of whether the partnership has remained in existence probably will depend on the facts and circumstances of the situation.

An additional wrinkle for this technique has been created by Rev. Proc. 2002-22, section 6.03, which provides that the Service generally will not issue a ruling if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership. As a practical matter, this provision implies that the IRS is reluctant to treat a partnership as terminating as a result of the distribution of an undivided interest to one of the partners. Although this requirement for a ruling is not likely to prevent some taxpayers from distributing undivided interests to partners prior to an exchange, it will certainly give pause to tax practitioners who are concerned about how the IRS may regard such transactions.

The lack of precedent notwithstanding, it is probably fair to say that this is the methodology most frequently used to deal with the common situation in which some partners want to reinvest and other partners want to cash out. There does not appear to be any policy reason why this transaction should be taxable to the reinvesting partners. After all, in our example Luke and Mary owned (through the partnership) an interest in real estate before the transaction, and they will own an interest in real estate (either directly or through the partnership) after the transaction. Why should they be subject to taxation when their economic position has not changed? For this reason, many practitioners have used this arrangement, although the more cautious ones have advised their clients concerning the risks involved (and, when possible, kept the partnership alive for the partners who want like-kind exchange treatment).

Installment notes. The third alternative, and one frequently used when there is a credit-worthy buyer of the relinquished property, is commonly referred to as the "installment note" method. Under this approach, the buyer conveys to the seller cash to be used for the purchase of the replacement property plus an installment note that could be distributed to the cashout partners in liquidation of their interests.

Applying this method to our example, the buyer would convey to JKLM, in exchange for the relinquished property, cash of $5 million (which would be paid to a QI) plus an installment note for $5 million. The note typically would provide for 98% or 99% of the payments thereon to be made a short time after closing, with the remaining payments to be made after the beginning of the next tax year, thus qualifying for installment reporting under Section 453(b)(1). If the buyer is credit-worthy, no other assurances of

payment might be needed; if there are questions concerning the buyer's financial ability to satisfy the note, a standby letter of credit might be obtained by the parties. **45**

This method "works" because no gain or loss is recognized by JKLM on receipt of the installment note (although

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there are certain exceptions to nonrecognition under Section 453, such as sales of inventory and depreciation recapture). Furthermore, the distribution of the installment note to Jack and Karen in redemption of their interests in JKLM also should not result in recognition of gain under Sections 453 and 731. **46** Instead, Jack and Karen would recognize gain only as payments are received on the note. JKLM, now comprising only the remaining two partners (Luke and Mary), would purchase replacement property, which clearly would qualify for tax deferral under Section 1031 because the partnership had held the relinquished property and acquired the replacement property.

SWAP AND DROP; DROP AND SWAP

Another frequently encountered pair of questions are whether a taxpayer who receives replacement property in an exchange can immediately transfer the property to a partnership (a "swap and drop" transaction), and whether a taxpayer can exchange property received in a distribution from a partnership (a "drop and swap" transaction).

Drop and Swap Transactions

Turning first to drop and swap transactions, the issue (discussed briefly above in connection with partnership transactions) is whether a transfer of the relinquished property from a partnership to the taxpayer immediately before an exchange violates the "held for" requirement under Section 1031(a)(1).

The requirement applies to both relinquished and replacement properties. The statutory language, however, does not indicate explicitly whether the acquisition of relinquished property in a nonrecognition transaction immediately before a like-kind exchange would disqualify the subsequent exchange from nonrecognition treatment. Because Congress has remained silent on this issue, taxpayers have been left to rely on holdings by the IRS and the courts.

IRS position. In several Rulings, the IRS has considered whether property acquired prior to a like-kind exchange satisfies the "held for" requirement under Section 1031(a)(1).

In Rev. Rul. 75-291, 1975-2 CB 332, corporation Y entered into a written agreement to acquire land and a factory owned by unrelated corporation X. Pursuant to this agreement, Y acquired another tract of land and constructed a factory on this land, and then exchanged the land and new factory for X's land and factory. Because Y acquired the property transferred to X "immediately prior to the exchange," the IRS

concluded that Y "did not hold such [relinquished] property for productive use in its trade or business or for investment." Thus, as to Y, the exchange did not qualify for nonrecognition of gain or loss under Section 1031(a). **47**

Rev. Rul. 77-297, 1972-2 CB 304, involved taxpayer A, who agreed to sell a ranch with the stipulation that the buyer (B) would cooperate to effectuate an exchange of properties should A locate suitable property. Once A located another ranch, owned by C, B purchased C's ranch and then exchanged this ranch with A for A's ranch. **48** With regard to B, the IRS concluded that the exchange of ranches did not qualify for nonrecognition of gain or loss under Section 1031 because "B did not hold the second ranch for productive use in a trade or business or for investment." **49** In reaching this conclusion, the Service cited Rev. Rul. 75-291, in which "it is held that the nonrecognition provisions of section 1031 do not apply to a taxpayer who acquired property solely for the purpose of exchanging it for like-kind property."

In Rev. Rul. 77-337, 1977-2 CB 305, the Service considered whether property acquired immediately prior to a like-kind exchange, through the liquidation of the taxpayer's wholly owned corporation, could satisfy the "held for" requirement. Individual taxpayer A was the sole owner of the stock of corporation X, which owned a shopping center. Under a prearranged plan, A first liquidated X and thereby acquired the shopping center, and then, immediately after the liquidation, transferred ownership of the shopping center to an unrelated party in exchange for like-kind property.

The IRS reasoned, without elaboration, that the "productive use of the shopping center by X prior to the liquidation cannot be attributed to A." As a result, the Service concluded that A's ownership of the relinquished property was insufficient to satisfy the "held for" requirement under Section 1031(a)(1).

In Ltr. Rul. 8414014, the IRS temporarily recognized that the holding of relinquished property by one consolidated group member could be attributed to another consolidated group member for purposes of the "held for" requirement. The IRS revoked Ltr. Rul. 8414014 after only eight months (without discussion of its reasoning), so this ruling should not be viewed as an example of the Service's current position on the "held for" requirement in the consolidated group context. **50** Nonetheless, this ruling demonstrates that the IRS has at least considered the possibility that the holding of property by one entity may be attributed to another entity in the "held for" analysis.

Ltr. Rul. 8414014 involved a consolidated group of corporations that operated telephone companies. In order to consolidate its operating territories, the group's parent (W) proposed, in part, to transfer all of the group's operating assets in states A and B to an unrelated corporation in exchange for operating assets located in state D. Prior to this transfer, W would cause one of its subsidiaries (X) to merge into a newly formed subsidiary (Newco) organized

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in state D and also included on W's consolidated return. **51** W would then cause another one of its subsidiaries (Y) to pay as a dividend to W all of its state A assets, and W would then transfer these assets to Newco in exchange for stock or securities. After these steps, Newco would exchange its state

A and B assets for the state D assets of the unrelated corporation.

Based on these facts, the IRS considered whether the use of property in a trade or business by one member of an affiliated group that files a consolidated return is "attributable to another member of the group to whom the property is transferred." The Service acknowledged that Rev. Rul. 77-337 could "arguably" preclude the application of Section 1031 to this exchange because Newco would acquire the relinquished property and immediately exchange such property. Nevertheless, the IRS concluded-at least until the revocation of this ruling-that the facts in Ltr. Rul. 8414014 were distinguishable from Rev. Rul. 77-337 because the state A assets "have been used in [a] trade or business by Corp. Y, another member of the Corp. W affiliated group."

Thus, pursuant to the "single economic entity theory of the consolidated return regulations," under which the individual members of a consolidated group are treated as divisions of the same economic entity, the IRS ruled that the use of the state A assets in a "trade or business within the affiliated group is attributable to Newco," and Newco's exchange of assets with the unrelated corporation would qualify for nonrecognition under Section 1031.

Once again, Ltr. Rul. 8414014 has minimal, if any, relevance because it was revoked by the IRS after only eight months. Despite this fact, Ltr. Rul. 8414014 reveals that, at least in the past, the IRS has had internal uncertainty on the issue of whether the use of property by one entity may be attributable to another entity in the context of the "held for" requirement under Section 1031(a)(1).

In Ltr. Rul. 9751012, the IRS again considered whether the use of relinquished property by one entity could be attributed to another entity. In this ruling, a taxpayer's two wholly owned subsidiaries and affiliate each transferred relinquished properties to a QI, pursuant to Reg. 1.1031(k)-1(g)(4). Following this transfer, and before the transfer of replacement properties, (1) the taxpayer liquidated its two subsidiaries under Section 332, and (2) the taxpayer's parent merged the affiliate into the taxpayer under Section 368(a)(1)(A). After these steps, the taxpayer organized wholly owned SMLLCs to hold each replacement property. The taxpayer requested a ruling that, in part, it would be treated as both the transferor of the relinquished properties and the transferee of the replacement properties in a like-kind exchange of such properties pursuant to Section 1031(a). [52]

The IRS focused its analysis on whether, under Section 381(a), the tax attributes of the taxpayer's liquidated subsidiaries and merged affiliate with regard to the relinquished properties would carry over to the taxpayer. Section 381(a) generally provides that, in the event of the acquisition of assets of a corporation by another corporation (which includes transactions under Section 332 and Section 368(a)(1)(D)), the acquiring corporation succeeds to and takes into account, as of the close of the day of distribution or transfer, the items of the transferor described under Section 381(c).

Because Section 381(c) does not specifically refer to like-kind exchanges, the IRS reviewed the legislative history of Section 381 to determine whether an entity's use of property for purposes of Section 1031 should carry over to its successor corporation. Quoting from a portion of this legislative history, the IRS pointed out that the purpose of Section 381 was "to enable the successor corporation to step into

the 'tax shoes' of its predecessor corporation without necessarily conforming to artificial legal requirements which [then existed at the time of its enactment] under court-made law." **53** The IRS also found no language in this legislative history to suggest that "the tax attributes listed in section 381(c) [should] be the exclusive list of attributes available for carryover."

Based on this broad reading of Section 381, the IRS treated the taxpayer in Ltr. Rul. 9751012 as if it stepped into the "tax shoes" of its liquidated subsidiaries and merged affiliate for purposes of Section 1031. Under this approach, the transfer of the relinquished properties by the taxpayer's subsidiaries and affiliate was attributed to the taxpayer. Accordingly, the taxpayer-and not its subsidiaries and affiliate-was treated as the transferor of the relinquished properties in a like-kind exchange for the replacement properties.

Although private letter rulings may not be used or cited as precedent, Ltr. Rul. 9751012 is significant because-unlike Ltr. Rul. 8414014-it demonstrates a clear recognition by the IRS that the use of property by one entity may be attributable to another entity for purposes of Section 1031.

One final inference can be drawn concerning the Service's view of this question. In Rev. Proc. 2002-22, section 6.03, the IRS stated that it generally will not issue a ruling if the co-owners held interests in the property through a partnership or a corporation immediately prior to the formation of the co-ownership. Thus, the IRS generally will not issue a ruling that a co-tenancy will be treated as the ownership of real estate if it is part of a proposed drop and swap transaction.

This curious statement could be read two ways. It could be viewed as the IRS continuing to draw the line in the sand that drop and swap transactions are impermissible. Alternatively, this statement could be viewed as a recognition by the Service that taxpayers regularly transfer property out of a partnership immediately before an exchange, and the IRS is simply not willing to state that there is no continuation of

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the partnership if the transferred interest is only an undivided fractional portion of the partnership's property. The latter view would be more consistent with the overall scope and purpose of Rev. Proc. 2002-22, which is intended to delineate when commonly owned property does not give rise to a partnership.

The Tax Court and Ninth Circuit. In *Bolker,* both the Tax Court and the Ninth Circuit rejected the Service's position, as set forth in Rev. Rul. 77-337, that property acquired prior to a like-kind exchange through the liquidation of a taxpayer's wholly owned corporation did not satisfy the "held for" requirement under Section 1031(a)(1).

Pursuant to an exchange agreement, the taxpayer ultimately exchanged his newly acquired property for other real property. Although the taxpayer caused the liquidation of his corporation under former Section 333 **54** and entered into an exchange agreement on essentially the same date, the exchange was not effectuated, and the taxpayer did not give up ownership of the relinquished property, until more than three months later.

The Tax Court concluded that the taxpayer's ownership of the relinquished property satisfied the "held for" requirement because (1) the taxpayer acquired the relinquished property in a tax-free transfer under old Section 333, and (2) the taxpayer held an economic interest in the relinquished property prior to such liquidation, and this interest was maintained after the liquidation and subsequent exchange of the property. In reaching its decision, the court referred to its reasoning in *Magneson,* which (as described in greater detail below) recognized that a taxpayer's post-exchange transfer of replacement property to a partnership under Section 721 did not violate the "held for" requirement. Because the taxpayer in *Magneson* did not hold the replacement property for sale, personal use, or for transfer as a gift, the Tax Court ruled that the holding of property "for a nontaxable contribution to a partnership under section 721 qualified as a holding for investment purposes under section 1031."

According to the Tax Court, *Magneson* entitled the taxpayer in *Bolker* to relief because in *Magneson* the exchange of properties was immediately followed by a tax-free Section 721 transfer; in *Bolker* the exchange of properties was immediately preceded by a tax-free acquisition under Section 333. In the view of the Tax Court, "[t]hat the tax-free transaction preceded rather than followed the exchange is insufficient to produce opposite results." In other words, the tax-free acquisition of relinquished property prior to an exchange-like the tax-free transfer of replacement property after an exchange-did not constitute the sale, conversion to personal use, or transfer as a gift of such property and, therefore, did not violate the "held for" requirement.

The Tax Court concluded further that, even aside from *Magneson,* the taxpayer's pre-exchange acquisition of the relinquished property satisfied the "held for" requirement because the taxpayer maintained a continuing economic interest in the relinquished property. In the taxpayer's liquidation of his wholly owned corporation under old Section 333, the court observed, the taxpayer surrendered stock in his corporation for real estate owned by the corporation, and continued to have an economic interest in essentially the same investment, although there was a change in the form of ownership.

As evidence of this continuity of ownership, the Tax Court pointed to the fact that the taxpayer's basis in the real estate acquired on liquidation equaled his basis in the stock surrendered, and the gain realized was not recognized but deferred until gain on the continuing investment was realized through a liquidating distribution. In short, the Tax Court concluded, "Section 333 recognizes the taxpayer's continuing investment in the real estate without the interposition of a corporate form." Thus, provided that a taxpayer exchanges the relinquished property for like-kind property and holds the replacement property for qualifying purposes under Section 1031(a), the taxpayer's exchange should qualify for nonrecognition treatment under Section 1031.

Although the Ninth Circuit affirmed the Tax Court's decision in *Bolker,* the appellate court established a more liberal interpretation of the "held for" requirement. According to the Ninth Circuit, the Service's position, as set forth in Rev. Rul. 75-291, Rev. Rul. 77-297, and Rev. Rul. 77-337, "would require us to read an unexpressed additional requirement into the statute that the taxpayer have, previous to forming the intent to exchange one piece of property for a second parcel, an intent to keep the first piece of property indefinitely."

The court rejected the Service's interpretation of the "held for" requirement, and instead held "that if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in trade or business or for investment' within the meaning of section 1031(a)."

The court continued that the "intent to exchange property for like-kind property satisfies the holding requirement because it is not an intent to liquidate the investment or to use it for personal pursuits." Under this rule, the taxpayer's pre-exchange acquisition of the relinquished property in *Bolker* satisfied the "held for" requirement-regardless of whether this acquisition was a nonrecognition transaction-because the taxpayer acquired this property with an intent to undertake a like-kind exchange with such property.

Practical advice. Where do all of these conflicting authorities leave us? What seems fairly clear is that the courts have not accepted the Service's contention that a "drop and swap" transaction is impermissible. Likewise, based on the private rulings that have been issued, it is not completely clear that the IRS itself believes that such transactions must be taxable. Unfortunately, there is no recent, clear guidance that specifically states that a "drop and swap" transaction would be allowable under Section 1031.

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What should a taxpayer (or his or her advisor) do in these circumstances? When the policy underlying Section 1031 is considered, it seems clear that the position adopted by the courts more clearly reflects Congress's intent than does the Service's position in the Revenue Rulings issued in the 1970s. Moreover, those Rulings were issued in a litigation context, which makes them doubly suspect. It would be beneficial to all taxpayers if the IRS were to recognize the inapplicability of those earlier Rulings and revoke them. Nevertheless, until the IRS does so, most taxpayers will continue to engage in drop and swap transactions, and their advisors usually will simply inform them of the risks involved but not attempt to prevent the transactions or otherwise disclose them on returns. **55**

Swap and Drop Transactions

The next issue is whether a "swap and drop" transaction, in which there is a post-exchange transfer of the replacement property to a partnership, jeopardizes the nonrecognition treatment of an exchange. This issue also turns on whether such transfer violates the "held for" requirement. Once again, the IRS and the courts have established opposing positions.

IRS position. In Rev. Rul. 75-292, 1975-2 CB 333, the IRS ruled that a taxpayer's transfer of replacement property to its wholly owned corporation violated the "held for" requirement.

The taxpayer transferred land and buildings used in its trade or business to W, an unrelated corporation, in exchange for land and an office building owned and used by W in its trade or business. Immediately

following this exchange, the taxpayer contributed its replacement property to a newly created corporation (Y) in a transaction that qualified under Section 351.

According to the IRS, the "held for" requirement was violated because its replacement property received from W "was to be transferred to Y and was not to be held by" the taxpayer. Although Rev. Rul. 75-292 does not include an in-depth discussion of how the IRS reached this decision, this Ruling established the Service's position that a taxpayer will violate the "held for" requirement if a corporate entity is interposed between the taxpayer and its replacement property immediately following the transfer of such property.

Put another way, based on Rev. Rul. 75-292 it appears that the IRS is unwilling to accept the view that the transferor's intent of transferring property into a corporation in exchange for stock (which will usually be held for investment) should carry over, which is contrary to the conclusion subsequently reached by the IRS in Ltr. Rul. 9751012.

Position of the courts. Rev. Rul. 75-292 does not indicate whether the interposition of a partnership between a taxpayer and its replacement property would violate the "held for" requirement. Nonetheless, in *Magneson* the IRS argued that its prohibition on post-exchange transfers of replacement property to controlled corporations, as established in Rev. Rul. 75-292, should apply to partnerships as well.

In *Magneson* the taxpayers transferred their fee interest in real property and an apartment building to X solely in exchange for a 10% undivided interest in commercial property. On the same day, (1) the taxpayers exchanged cash and their replacement property for a general partnership interest in a limited partnership in a transaction that qualified for nonrecognition treatment under Section 721, and (2) the limited partnership acquired the remaining 90% undivided interest of the taxpayers' replacement property.

In the Tax Court, the IRS argued that, on the contribution of the replacement property to the partnership, the taxpayers no longer satisfied the "held for" requirement under Section 1031(a)(1) because the partnership-and not the taxpayers-held the replacement property. The court disagreed with this analysis of the "held for" requirement.

In considering whether a taxpayer satisfied the "held for" requirement following its receipt of replacement property, the Tax Court did not focus its analysis on whether the taxpayer literally continued to hold such property. Rather, the court concluded that the taxpayers "merely effected a change in the form of the ownership of their investment instead of liquidating their investment." According to the Tax Court, "for tax purposes, joint ownership of the property and partnership ownership of the property are merely formal differences and not substantial differences." Thus, the taxpayers continued their ownership interest in the replacement property following their contribution of such property to the partnership and thereby satisfied the "held for" requirement under Section 1031(a)(1).

The Ninth Circuit affirmed, for similar reasons. The appellate court concluded that the taxpayers' contribution of the replacement property to a partnership did not violate the "held for" requirement because, at the time of the like-kind exchange, the taxpayers intended to and did continue to hold the

replacement property.

The circuit court agreed with the Tax Court that a mere change in the form of a taxpayer's ownership of replacement property did not constitute a per se violation of the "held for" requirement. According to the Ninth Circuit, so long as the taxpayers continue to own the property and to hold it for investment, "a change in the mechanism of ownership which does not significantly affect the amount of control or the nature of the underlying investment does not preclude nonrecognition under section 1031(a)." As the court explained further, the contribution of replacement property to a partnership would not significantly affect the nature of this investment as long as the taxpayers' interest in the partnership's underlying assets was of like-kind to their original investment.

The appellate court also considered the alternative argument posited by the IRS that, on application of the step transaction doctrine, the taxpayers would have transferred their interest in the relinquished property for a general partnership interest. The court reasoned that, even under this scenario,

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the taxpayers would have satisfied the "held for" requirement because the taxpayers as "general partners are the managers of their investment, just as they were when they owned the [relinquished property] in fee simple."

As the Ninth Circuit made clear, however, its discussion of the step transaction doctrine in *Magneson* was merely dicta because "it is not readily apparent" that the transaction could have been achieved in fewer steps. Under this doctrine, a taxpayer may not secure, by a series of contrived steps, different tax treatment than if it had carried out the transaction directly. **56**

In *Magneson,* the intent of the exchange parties was to end up as co-owners of the partnership that held the entire replacement property. Because the value of the relinquished property was 10% of the entire replacement property, the taxpayers planned to "pay" for their share of the replacement property with the relinquished property.

If the parties had not undertaken a like-kind exchange, the taxpayers also could have achieved their desired result by (1) selling the relinquished property, (2) using the proceeds to buy 10% of the replacement property, (3) contributing this interest to a partnership, and (4) having the co-owner of the replacement property contribute its 90% share of the replacement property to the same partnership. This scenario involves more steps (four) than the like-kind exchange (three). **57**

Alternatively, the taxpayers could have (1) contributed the relinquished property to a partnership, (2) caused the other exchange party to contribute 90% of the replacement property to the same partnership, and (3) caused the partnership to exchange (prior to Section 1031(a)(2)(D), as discussed below) the relinquished property for the remaining 10% of the replacement property. This alternative involves the same number of steps (three) as in the like-kind exchange. Nonetheless, the Ninth Circuit concluded that the step transaction doctrine should not apply because between two equally direct ways of achieving the

same result, the taxpayers "were free to choose the method which entailed the most tax advantages to them."

If the Ninth Circuit had accepted the Service's argument in *Magneson* that the step transaction doctrine should apply-and thereby treated the taxpayers as if they transferred their interest in the relinquished property for a general partnership interest-one could argue that the 1984 amendment to Section 1031 diminished *Magneson*'s precedential value.

As noted above, Section 1031 was amended to exclude partnership interests from qualifying as replacement or relinquished property in a like-kind exchange. As described in the Senate Report accompanying DRA '84, Congress enacted Section 1031(a)(2)(D) because it was "particularly concerned by the use of the like-kind exchange rules to facilitate the exchange of interests in tax shelter investments for interests in other partnerships." **58** "Under this arrangement," the Report states further, "taxation of the gain inherent in an interest in a 'burned out' tax shelter partnership-i.e., a partnership which has taken substantial deductions for nonrecourse liabilities without actually paying off such liabilities, and hence without the partners suffering real economic loss-may be able to be avoided if the interest is exchanged, tax-free, for an interest in another partnership...."

Because neither the Ninth Circuit nor the Tax Court treated the like-kind exchange in *Magneson* as an exchange of property for a partnership interest, the subsequent introduction of Section 1031(a)(2)(D) should have no bearing on *Magneson*'s continuing vitality. Furthermore, as the legislative history of Section 1031(a)(2)(D) makes clear, the rationale of Congress in excluding partnership interests from Section 1031 is inapplicable.

In addition, as described above, in *Bolker* the Ninth Circuit affirmed the Tax Court's decision that Section 1031 does not require a taxpayer to hold relinquished property for a minimum period before such property is transferred as part of a like-kind exchange. For purposes of determining whether the post-exchange contribution of replacement property to a partnership violates the "held for" requirement, the Ninth Circuit's decision in *Bolker* is significant because it set forth the rule that if a taxpayer acquires property which "he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in trade or business or for investment' within the meaning of section 1031(a)."

Similarly, in *Maloney,* 93 TC 89 (1989), the Tax Court considered whether the liquidating distribution of replacement property to a corporation's controlling shareholder nearly one month following a like-kind exchange involving such property violated the "held for" requirement. As the court pointed out, pre-exchange transfers of relinquished property and post-exchange transfers of replacement property do not violate the "held for" requirement if, as established in *Magneson* and *Bolker,* the taxpayer intends to continue holding the relevant property for investment or for use in a trade or business, and the taxpayer's ownership interest in such property continues.

Under this rule, the transfer of replacement property to a corporation's controlling shareholder did not diminish the shareholder's investment intent and continuity of ownership with regard to such property

because "[a]s we understand *Magneson* and *Bolker,* the mere addition of another nontaxable transaction (at least, a transaction exempted by section 721 or 333) does not automatically destroy the nontaxable status of the transaction under section 1031."

Practical advice. The conclusion that can be drawn from the cases involving swap and drop transactions is the same as that can be drawn from the authorities concerning drop and swap transactions-the courts have approved these transactions even if the IRS has not. Moreover, the Service's reasoning in its old, litigation-related

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Rulings is questionable, whereas the courts have looked at the rationale underlying the statute and approved the exchanges.

The most significant legal issue is whether the results in the cases would somehow be altered by the enactment of Section 1031(a)(2)(D), which provides that a partnership interest does not constitute replacement property. The IRS might argue, on the basis of the step-transaction doctrine, that a swap and drop transaction is, in substance, the acquisition of a partnership interest as replacement property, which is impermissible under Section 1031(a)(2)(D). Specifically, the IRS could argue that the seller of the replacement property should be deemed to have transferred that property to a partnership and then have transferred the partnership interest to the taxpayer.

Although there are no authorities squarely on this point, the better view is that the exchange should be tested for what occurred-real property was exchanged for real property-and the subsequent "drop" of the replacement property into another entity should be separately tested for taxability. The courts have rejected the application of the step transaction doctrine in analyzing like-kind exchanges where the taxpayer's method was as direct as any alternatives. This approach is more consistent with the Service's recent Rulings concerning reorganizations in which the IRS distinguished between post-reorganization transfers and the taxability of the reorganization itself. **59**

The biggest issue that confronts tax advisors is the level of comfort that should be given to clients who engage in swap and drop transactions. Because there is no clear guidance on point, appropriate cautions should be voiced. Nevertheless, the weight of the law (and congressional intent) appears to support such transactions, so that most practitioners will simply provide warnings but neither try to prevent such transactions nor disclose them on tax returns.

CONCLUSION

Even with the issuance of new guidance, **60** many issues remain in applying Section 1031 to various types of transactions. Although a "state of the art" is emerging from the legal undergrowth, these issues will keep tax practitioners occupied for many years to come.

Glossary

- **AP** Accommodation party; before the IRS established safe harbors for reverse exchanges using EATs (see below), an AP was needed to invest in either the replacement or the relinquished property.
- **EAT** Exchange accommodation titleholder; a party other than the taxpayer or a disqualified person who facilitates a reverse exchange. See Rev. Proc. 2000-37, 2000-2 CB 308.
- **QEAA** Qualified exchange accommodation agreement; a fundamental concept underlying the reverse exchange safe harbor. See Rev. Proc. 2000-37, 2000-2 CB 308.
- **QI** Qualified intermediary; a person who facilitates a deferred exchange. See Reg. 1.1031(k)-1(g)(4).
- **SMLLC** Single-member limited liability company, an entity disregarded as separate from its owner, and often used to hold title to real estate.
- **TIC** Tenancy in common, a form of property ownership under state law in which each co-tenant owns an undivided interest in the entire property.

Practice Notes

The tax treatment of nonrecognition exchanges under Section 1031 has been evolving rapidly in the last few years, with many taxpayer-friendly developments. Nevertheless, practitioners must be aware of remaining areas of uncertainty, which include the following:

- Even though the federal income tax consequences of safe harbor reverse exchanges appear to be clear, the state and local consequences are much less certain, i.e., whether the form of the transaction will be respected for income tax purposes, and whether treatment of the EAT as the taxpayer's agent will avoid doubled-up real estate transfer taxes.
- It is not clear whether a taxpayer that initially acquires replacement property through an EAT, and is unable to dispose of the relinquished property within the 180-day period provided for in the safe harbor, can subsequently convert the transaction into a non-safe-harbor reverse exchange.
- There still is no definitive guidance on whether a taxpayer can encumber the relinquished property before the exchange; such transactions are risky, particularly if the relinquished property is encumbered *immediately* before the exchange.
- An open question with respect to TIC arrangements is whether the co-owners can delegate authority to the property manager to approve leases that follow an approved form and guidelines. While this approach would be a practical means of mitigating the difficulty of obtaining approval of each lease and should not adversely affect the tax treatment of a TIC, as of now it has not been approved by the IRS.
- One of the most controversial aspects of Rev. Proc. 2002-22 is a provision that would mandate that the individuals who own the interests in the SMLLC that actually holds the TIC interest would be personally liable to contribute cash to the SMLLC in the event that any other

co-owner made an advance to cover operating deficits. As a practical matter, the effect of this provision would be to convert potentially nonrecourse liabilities into recourse obligations.

- The rule in Rev. Proc. 2002-22 that the property manager cannot be a lessee in the property would prevent the property manager from having an on-site office; counsel generally have become comfortable that this requirement can be ignored where an unrelated property manager is paying an arm's-length rent for the space.
- If a selling partnership distributes undivided TIC interests in redemption of their partnership interests to the "cash-out" partners immediately before the sale, or to all of the partners in liquidation of the partnership, two issues that arise are (1) whether Section 1031's "held for use" requirement is met, and (2) whether a deemed partnership may be found under Section 761, particularly if the operation and management of the property involves a significant level of activity.
- No recent, clear guidance specifically states that a "drop and swap" transaction would be allowable under Section 1031.

1 Lipton, "The 'State of the Art' in Like-Kind Exchanges," 91 JTAX 78 (August 1999).

2 See Lipton, "New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty," 93 JTAX 327 (December 2000), and Lipton, "New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges," 96 JTAX 303 (May 2002).

3 See Levine, 567-2nd T.M. (BNA), *Taxfree Exchanges Under Section 1031*; Cuff, "Real Estate and the Deferred Exchange Regulations," ALI-ABA Course of Study: Creative Tax Planning for Real Estate Transactions (1997); Egerton and Sowell, "Like Kind Exchanges of Real Properties," 11 Tax Mgt. Real Est. J. 189 (1995).

4 Under Section 1031(a)(2), the properties involved in a like-kind exchange may not be stock in trade or other property held for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust; or beneficial interests or choses in action.

5 If a loss is realized on a like-kind exchange in which boot is received, the loss is not recognized.

6 In contrast, if the taxpayer *receives* cash or nonqualifying property to compensate for differences in net value as a result of liabilities, the cash or nonqualifying property is taxable boot.

7 For purposes of this rule, Sections 267(b) and 707(b) apply to determine if two persons are related.

8 Barker, 74 TC 555 (1980).

9 Reg. 1.1031(k)-1(c)(4).

10 This rule does lead to questions, however, as to what constitutes a "property" for purposes of Section 1031. See Shop Talk, "Identification of Replacement Property-What Is a 'Property'?," 88 JTAX 190 (March 1998), and "More on Identification of Replacement Property Under Section 1031," 89 JTAX 62 (July 1998).

11 Reg. 1.1031(k)-1. See, e.g., Handler, "Final Regs. on Deferred Like-Kind Exchanges Provide Additional Clarification," 75 JTAX 10 (July 1991).

12 See, e.g., H.R. 22, 1/7/03 (the "Individual and Small Business Tax Simplification Bill of 2003," introduced by Rep. Houghton, R-N.Y.).

13 Thus, the key distinction between a swap-last transaction and a swap-first transaction was whether the AP held the replacement property or the relinquished property.

14 In contrast, most aircraft are exchanged using the swap-first structure, because the EAT, for liability reasons, does not want legal title to the replacement plane being used by the taxpayer; the relinquished property (the old airplane) is not used while held for sale.

15 For purposes of Rev. Proc. 2000-37, 2000-2 CB 308, a "disqualified person" has the same meaning as set forth in Reg. 1.1031(k)-1(g)(4)(iii)(A), cross-referencing Reg. 1.1031(k)-1(k). This definition includes, among other persons, (1) an agent of the taxpayer at the time of the transaction (which generally includes anyone who, within the preceding two years, was the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker); (2) anyone whose relationship with the taxpayer is described in Section 267(b) or 707(b), substituting 10% for 50%; and (3) anyone whose relationship to an agent of the taxpayer, as defined in (1), is described in Section 267(b) or 707(b), again substituting 10% for 50%.

16 The taxpayer may identify any three properties or an unlimited number of properties that do not have an FMV (without regard to any indebtedness that encumbers such properties) in excess of 200% of the FMV of the replacement property.

17 For real estate, a legal description of the property is not required; a street address or commonly used name for the property is sufficient. For personal property, only the particular type of property must be identified.

18 This fear was confirmed by TAM 200039005.

19 Under the short-term obligation exception in Section 1272(a)(2)(C), the OID rules do not apply to debt instruments with a fixed maturity date not more than one year from the date of issue.

20 This conclusion is buttressed by Ltr. Rul. 200251008, discussed in more detail below, in which the presence of an EAT permitted the taxpayer to engage in an indirect exchange with a related party. See the text accompanying notes 24 and 25, *infra.*

21 See Shop Talk, "Tax Court Disapproves a Pre-Safe-Harbor Reverse Exchange," 94 JTAX 188 (March 2001).

22 H. Rep't No. 101-247, 101st Cong., 1st Sess. 1340 (1989).

23 *Id.,* page 1341.

24 Under Reg. 1.1031(a)-1(c)(2), a leasehold interest with 30 years or more to run is treated as an interest in real estate for purposes of a like-kind exchange.

25 The taxpayer would recognize gain only to the extent that the planned improvements were not completed within the exchange period, in which event gain would be recognized to the extent of the boot received. See generally Borden, Lederman, and Spear, "Build-to-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment," 98 JTAX 22 (January 2003).

26 The lender would have committed to make a loan secured by the replacement property, so the lender would be entitled to a fee if the taxpayer did not use the proffered financing.

27 Under Temp. Reg. 15A.453-1(b)(2)(iv), however, indebtedness placed on property in contemplation of a disposition is not qualifying indebtedness for purposes of the installment sale rules. The IRS could refer to this rule by analogy as support for its position that indebtedness placed on property prior to a like-kind exchange results in boot.

28 Generally, with certain limited exceptions, a nonqualified liability is a liability not incurred to acquire property and which was incurred within two years of the date of transfer of property to the partnership. See Reg. 1.707-5(a)(6).

29 See also Rev. Rul. 79-77, 1979-1 CB 448, which did not find a business entity where three

individuals transferred ownership of a commercial building subject to a net lease to a trust of which the three individuals were the beneficiaries.

30 Unless a partnership existed, the statute of limitations might have expired for any determination with respect to the tax consequences of the equipment leases, which were part of a 1980s-type tax shelter.

31 Bussing, 88 TC 449 (1987), *reconsideration denied* 89 TC 1050 (1987); Alhouse, TC Memo 1991-652 62 CCH TCM 1678 TCM ¶91652 .

32 See Lipton, *supra* note 2, 96 JTAX 303.

33 There is a possibility, however, that the liability shield generally provided by an LLC may not be available in some jurisdictions for an SMLLC because a court might characterize this entity as the alter ego of the single owner, and impose liability.

34 In the 20 states where the Uniform Partnership Act (UPA) is still in effect (such as New York), a variation on TIC ownership can arise. Under UPA section 25, each general partner has a direct interest in the underlying partnership property, although no general partner can act alone with respect to the property. This provision applies to all property, whether personal or real. When such property is realty, the consequence is a "tenancy in partnership" that is akin to a TIC.

35 If the proposed action requires approval of only a majority of the co-owners, approval is deemed given if fewer than 50% of the co-owners object.

36 See Rev. Proc. 2002-22, 2002-1 CB 733, section 6.12.

37 *Id.,* section 6.06.

38 In addition, many lenders require the issuance of a "substantive non-consolidation" opinion, which means that the SMLLC would not be consolidated with its individual owner in the case of a bankruptcy filing by the individual owner; compliance with the parenthetical clause in section 6.08 of Rev. Proc. 2002-22 is likely to prevent counsel from being able to issue a substantive non-consolidation opinion.

39 The as-yet unnumbered letter ruling issued on 3/7/03 (see the text accompanying note 35, *supra*) did not address this issue because there was neither debt financing nor any indication that the TIC interests were held through SMLLCs.

40 See sections 6.11 through 6.15 of Rev. Proc. 2002-22.

41 As this article was going to print, IRS issued a new Ruling affecting partnerships that give up the relinquished property in one year but do not acquire the replacement property until the following tax year. Rev. Rul. 2003-56, 2003-23 IRB 985, allows any net decrease in a partner's share of the partnership's liability to be taken into account in the year in which the relinquished property is transferred, but any net increase in such share is not taken into account until the year in which the replacement property is received. In effect, partnerships are placed on a par with individuals where an exchange straddles two years.

42 For other issues related to this scenario, see generally Crnkovich and Lowy, "Planning for UPREIT Transactions When Selling Partners Want to Go Their Separate Ways," 90 JTAX 238 (April 1999).

43 See also Maloney, 93 TC 89 (1989), and Wagensen, 74 TC 653 (1980). But compare Barker, 60 AFTR 2d 87-5507 668 F Supp 1199 87-2 USTC ¶9444 (DC Ill., 1987), and Weintrob, TC Memo 1990-513 PH TCM ¶90513 60 CCH TCM 895 .

44 If the property is leased by the partnership to a master lessee on a triple-net basis, and undivided interests (subject to the master lease) are then distributed to the partners, it seems fairly clear that the co-ownership arrangement should not be recharacterized as a partnership under Sections 7701 and 761.

45 A standby letter of credit is not treated as payment under Temp. Reg. 15A.453-1(b)(3)(i). Because most of the payments on the note will be made shortly after the closing, the cost of the standby letter of credit usually is not significant.

46 The redemption of the interests of Jack and Karen, who own 50% of JKLM, does not cause a termination of JKLM under Section 708(b)(1)(B) because a redemption is not treated as a "sale or exchange" for this purpose.

47 The IRS also ruled that, as to X, the exchange of land and factories between X and Y qualified under Section 1031 because X's ownership of the relinquished and replacement properties satisfied the "held for" requirement.

48 As part of this transaction, A assumed B's liability under the note B had issued to C.

49 Once again, the IRS ruled that the other party to the exchange, A, undertook an exchange that qualified under Section 1031 because A's ownership of the relinquished and replacement properties

satisfied the "held for" requirement.

50 Ltr. Rul. 8548013 (revoking Ltr. Rul. 8414014 after reviewing the ruling "as to pertinent and appropriate factual information given and applicable law," but without further discussion).

51 This change in place of organization was required by a state D law that assets used in telephone operations in the state be held by a state D corporation.

52 As described below, the taxpayer also asked for a ruling that the acquisition of each replacement property by a separate LLC wholly owned by the taxpayer would be deemed an acquisition by the taxpayer and would not violate the "held for" requirement.

53 Quoting from S. Rep't No. 1622, 83rd Cong., 2d Sess. 52 (1954).

54 Prior to its repeal in 1986, Section 333 provided nonrecognition treatment on the liquidation of a domestic corporation by its noncorporate shareholder.

55 Based on the case law, it seems that, more likely than not, such transactions would be treated as nontaxable exchanges, so that disclosure is not required.

56 Citing Crenshaw, 28 AFTR 2d 71-5846 450 F2d 472 71-2 USTC ¶9698 (CA-5, 1971), *cert. den.*

57 The like-kind exchange involves (1) an exchange of like-kind properties, (2) the contribution of a 10% ownership interest by taxpayers, and (3) the contribution of a 90% ownership interest by the other exchange party.

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

59 Rev. Rul. 2001-24, 2001-1 CB 1290, and Rev. Rul. 2002-83, 2002-2 CB 927.

60 IRS continues to devote attention to Section 1031 issues. In Rev. Proc. 2003-39, 2003-22 IRB 971, the Service provided safe harbors for like-kind exchange programs involving ongoing multiple exchanges of personal property and a single QI.

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