

Tax Deferred Like-Kind Exchanges: more on the menu than just swapping deeds

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Terminology and Requirements

- Taxpayer (“**TP**”) exchanges “**relinquished property**” (given up) for “**replacement property**” (received).
- The **same taxpayer** must start and finish the exchange.
- *Both* relinquished and replacement property must be “**held for investment or for productive use in a trade or business**”
 - Dealer property/inventory is not eligible. Neither is personal.
 - But you can change your mind. *Reesink v. C.I.R.*, T.C. Memo. 2012-118 (2012).
- Relinquished and replacement property must be “**like-kind**”
 - Multi-class exchanges exist. Treas. Reg. 1.1031(j)-1.
- Non-like kind property is “**boot.**” Boot triggers gain.

Exchange Metrics

- Gain **realized** as usual
(amount realized minus basis)
- Realized gain **recognized** to the extent of boot
 - Cash is boot (and so is property not of like-kind)
 - Reduction in debt is boot
(debt going in \leq debt coming out)
 - Additional cash treated as purchasing boot.
- Basis = basis + gain – boot + additional cash/etc.
 - Unrecognized gain is deferred.

Like-Kind *Real* Property

- Classes of real property irrelevant.
- State law for fixture vs. equipment (mostly). CCA 201238027. Particularly thorny for wellheads, pipelines, and “green” buildings.
- 30+ year lease. Treas. Reg. 1.1031(a)-1(c).
 - Even in sale-leaseback (provided respected for tax purposes). *Century Elec. Co. v. C.I.R.*, 192 F.2d 155 (8th Cir. 1951).
- Disregarded Entities holding assets like-kind to real property.
- Tenant-in-common interests in real property. Rev. Proc. 2002-22.
(Discussed at length below)
- Easements. Rev. Rul. 72-549.
- Remainder interests (but not in exchange for granting a life estate). Rev. Rul. 72-601.
- Mineral Interests. *C.I.R. v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).
 - Royalty trusts are a common alternate investment right now.
- BUT: foreign is **not** like-kind to domestic. IRC 1031(h)(1).

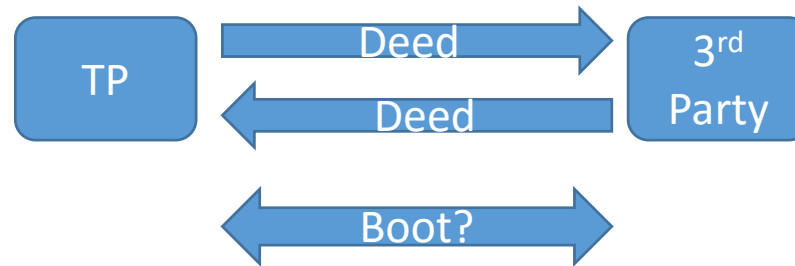
Like-Kind *Personal* Property

- Depreciable Tangible: Treas. Reg. 1.1031(a)-2(b)
 - 1: General Asset Classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56.
 - 2: Product Classes (6-digit NAICS codes per 2002 manual)
- Nondepreciable Tangible & Intangible:
 - no classes given. Treas. Reg. 1.1031(a)-2(c).
- Domestic vs. Foreign: based on “predominant use” IRC 1031(h)(2).
- Livestock of different genders aren’t like-kind. IRC 1031(e).

Related Party Exchanges

- IRC 1031(f) exchanges between “related” parties
 - “Related” from IRC 267(c) and 707(b)
 - Family: siblings, spouse, ancestors, & descendants (no uncles or cousins)
 - Generally for entities: >50% common ownership
 - Entity-entity
 - Owner-entity
 - Beware ownership attribution rules (*incl. reattribution*)
 - Generally proportionate entity-owner attribution
- Disposition within 2 years triggers gain for *both* related parties.
 - Exclude: death, compulsory/involuntary conversion (if exchange before threat or imminence)
- Substantial diminution of risk (i.e. puts/calls/short sales) stops the 2-year clock. IRC 1031(g).

So far, it's all based on this Unrealistically Simple Example



But what if you need to
buy later (or buy and sell
with different people)?

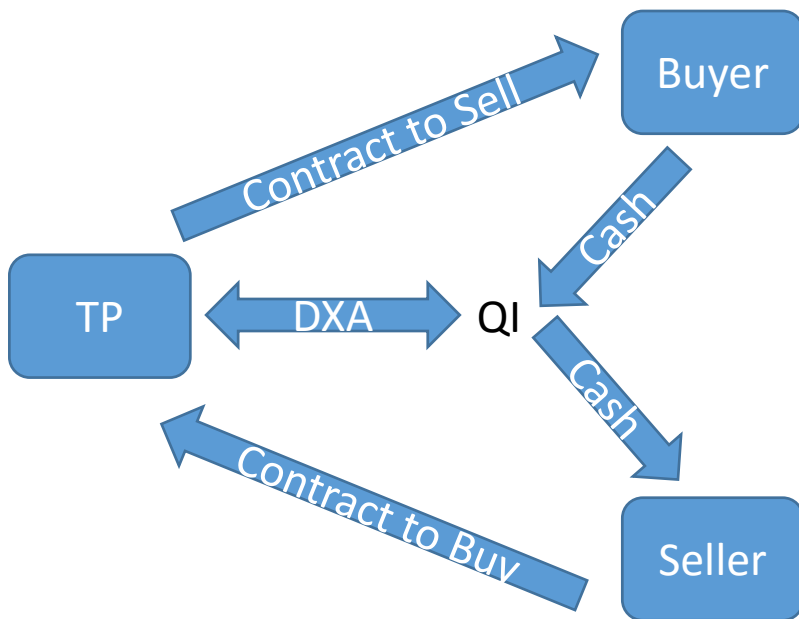
Deferred Exchanges

- Treas. Reg. 1.1031(k)-1.
- Qualified Intermediary (“**QI**”) exchanges property for property (handling the cash in the middle).
 - QI must not be TP or certain related persons.
 - QI is not the agent of the taxpayer. Treas. Reg. 1.1031-(b)-2.
- QI must have written Deferred Exchange Agreement (“**DXA**”) with TP meeting requirements in Treas. Reg. 1.1031(k)-1, esp. -1(g)(6).
 - Biggest surprise: “excess” QI funds not available until exchange completed (or failed).

Typically this means waiting the full 180 days.

Treas. Reg. 1.1031(k)-1 also allows use of “qualified escrow account” or “qualified trust” instead of QI, but relatively uncommon and generally similar to QI in mechanics.

Deferred Exchange Process



- TP contracts to sell (assigned to QI prior to close)
- QI receives proceeds of sale
- ...
- TP identifies replacement property candidate(s)
- ...
- TP contracts to buy (assigned to QI prior to close)
- QI purchases with proceeds

Contracts and deeds are between TP and Buyer/Seller

Deferred Exchange Timeline

- **45 days** to identify (in writing)
 - 3 Property Rule
 - 200% Rule: (total FMV identified \leq 200% FMV relinquished property)
 - 95% Rule: if using 200% Rule, must close at least 95% of FMV of identified property)
 - Property closed before 45 days is deemed identified.
 - Identification must be “unambiguously” described.
- **180 days** to close
 - Must be “substantially the same property” as identified
 - QI generally must hold unused funds until 180 days ends.

1031 Cooperation Clause

- Lightweight:

Buyer is aware that Seller intends to perform an IRC Section 1031 tax deferred exchange. Seller requests Buyer's cooperation in such an exchange and agrees to hold buyer harmless from any and all claims, costs, liabilities, or delays in time resulting from such an exchange. Buyer agrees to an assignment of this contract by the Seller.

- Heavyweight:

If Seller elects to enter into a 1031 exchange as part of this transaction, Purchaser will cooperate with Seller in the exchange, provided, however, that Purchaser shall not be obligated to pay any fees, costs, or expenses in connection therewith.

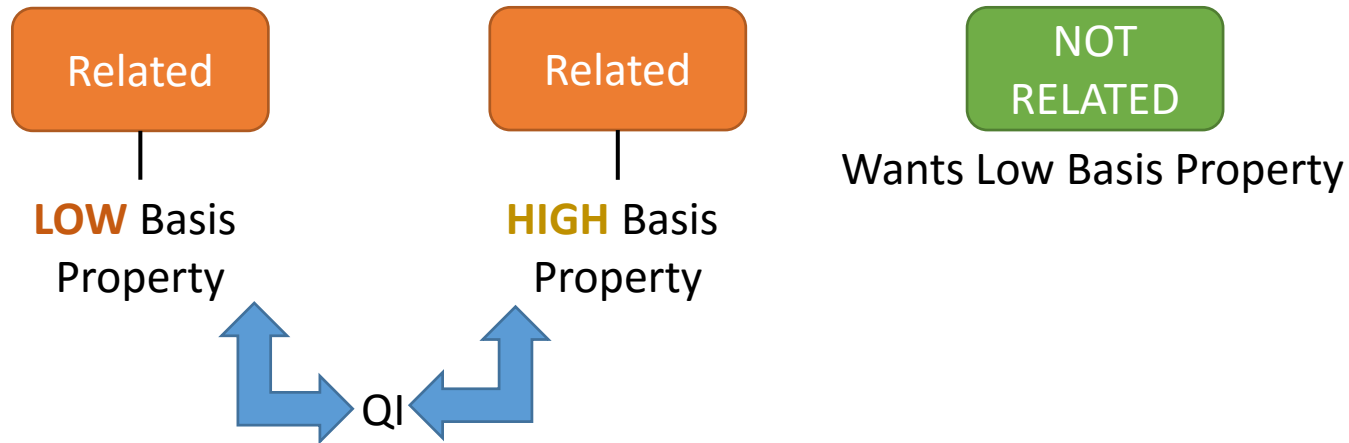
If Seller elects to pursue a 1031 exchange, Seller agrees (i) to pay all fees and closing costs associated with the exchange of property contemplated hereunder, including but not limited to fees payable to the intermediary and the cost of title insurance for the exchange property, and (ii) to reimburse Purchaser for any actual out-of-pocket costs incurred by Purchaser at the request of the Seller in support of the 1031 exchange.

Related Deferred Exchanges

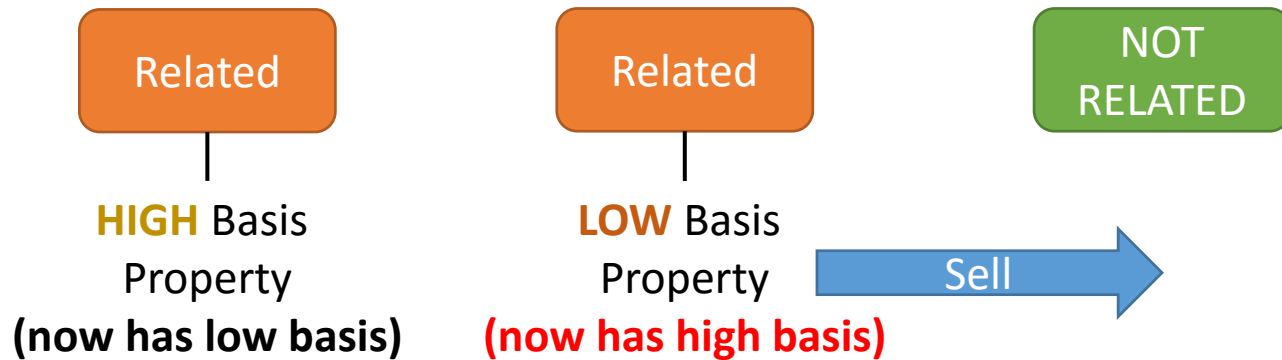
- Strictly speaking, 1031(f) doesn't apply to QIs
 - “Related” would be excluded from serving as a QI because “disqualified person”
 - Surprisingly, 1031(f) doesn't “look through” the QI
- BUT 1031(f)(4) anti-abuse rule applied consistently.
“any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection [1031(f) on related party exchanges]”
- Cases seek out high-low basis swaps & cash-out.
 - *Ocmulgee Fields, Inc. v. C.I.R.* 132 T.C. No 6 (2009).
 - *Teruya Brothers, Ltd. v. C.I.R.*, 580 F.3d 1038 (2009).

High-Low Basis

Step 1:

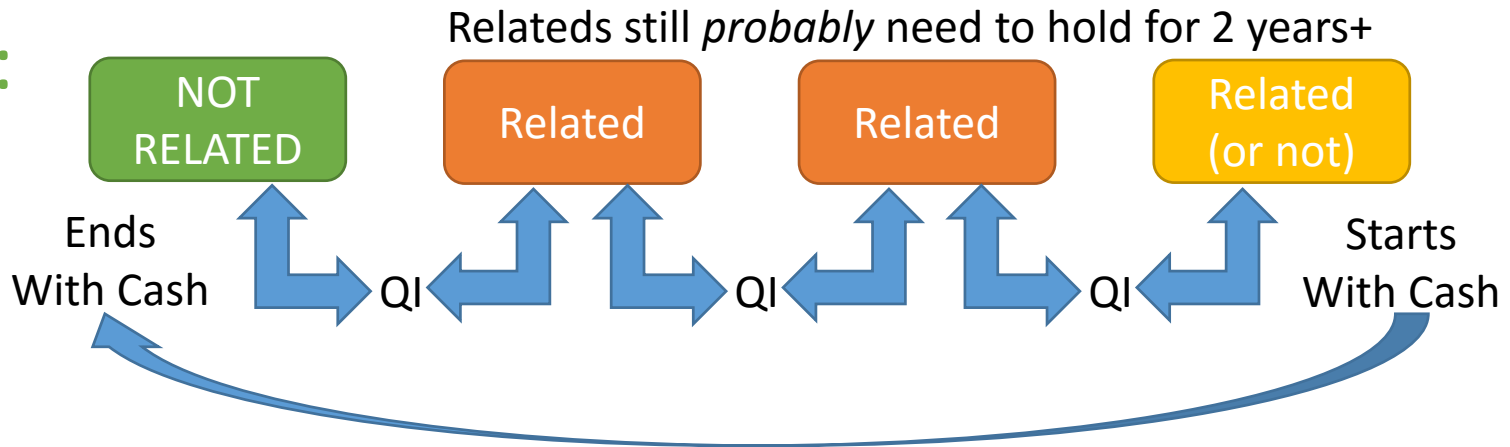


Step 2:



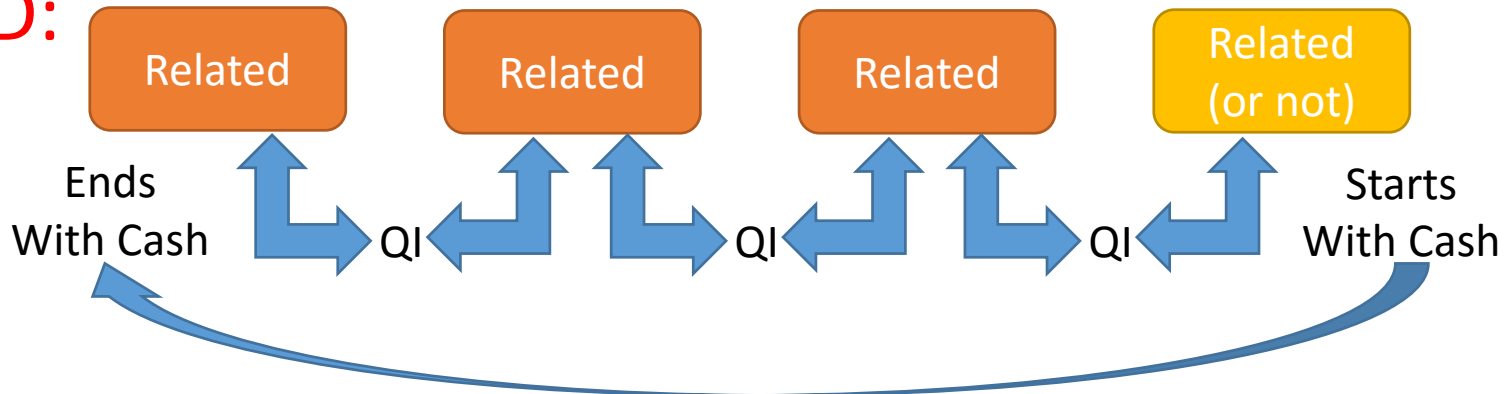
Cash-Outs

OK:



See PLRs 200810016, 200810017, 200820017, 200820025, and 201048025

BAD:

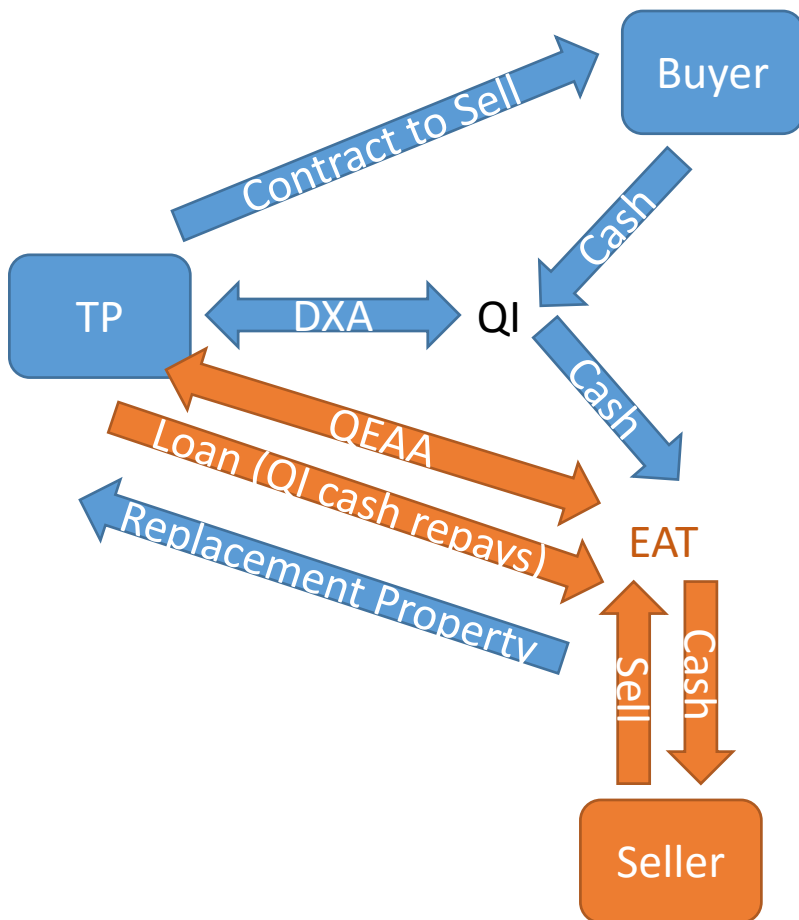


But what if you need to
buy *before* you sell?

Reverse Exchanges

- Safe Harbor: Rev. Proc. 2000-37
 - Imports as much as possible from Treas. Reg. 1.1031(k)-1.
 - Qualified Exchange Accommodation Agreement (“QEAA”)
 - Exchange Accommodation Titleholder (“EAT”) acquires “qualified indicia of ownership” of replacement property.
 - TP may fund EAT’s acquisition. TP may lease from EAT. (Rev. Proc. 2000-37 is permissive on non-market terms)
 - 45 days to identify & 180 days to close *from date EAT obtains “qualified indicia”* (otherwise just like in a deferred exchange).
 - Typically use QI in a deferred exchange to sell relinquished property and acquire replacement property from EAT.
- Non-Safe Harbor: *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979).

Reverse Exchanges



- EAT acquires “qualified indicia”
 - TP usually funds this
- ...
- TP identifies *relinquished* property candidate(s) to EAT.
- ...
- TP uses QI in deferred exchange to sell/etc.
- QI pays EAT and EAT repays funding (usually to TP)

EATs and Build-to-Suit

- Treas. Reg. 1.1031(k)-1(e) allows deferred exchange identifying “replacement property to be produced”
- Rev. Proc. 2000-37 allows EAT to improve property while holding the “qualified indicia.”
 - Recall that the TP can fund EAT.

BUT:

- Must still close within 180 days.
 - Subsequent improvements are not part of the exchange. Unspent QI funds are still boot even if used for later improvements.
- Rev. Proc. 2004-51: TP cannot hold replacement property within 180 days before EAT acquires qualified indicia
- Rev. Proc. 67-255: improvements on real property are not like-kind to real property

Can a 30+ year lease from affiliate work?

Collective Ownership of Like-Kind Property

Entities are not like-kind

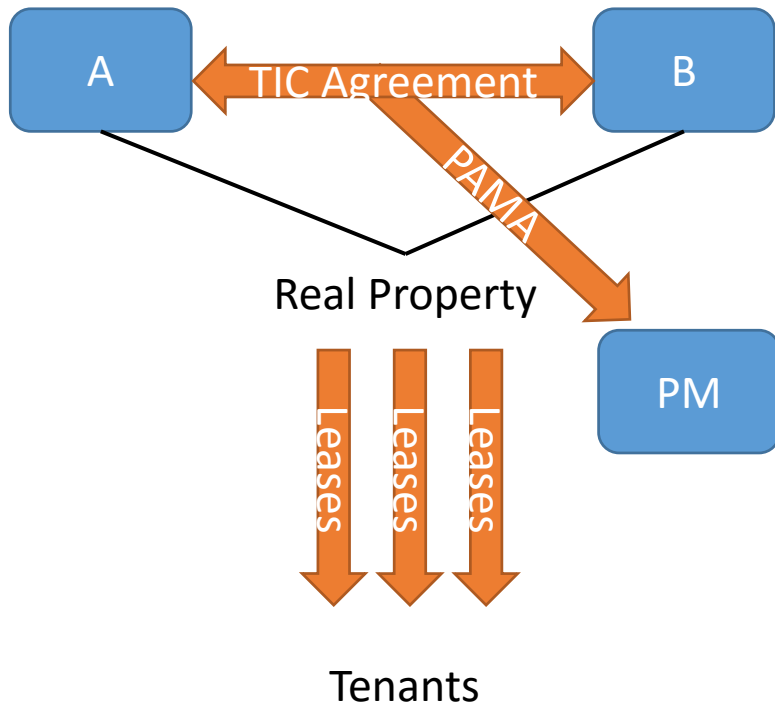
IRC 1031(a)(2) excludes (among others):

- Stocks, bonds, notes
- Securities or evidences of indebtedness or interest
- Interests in partnerships
- Certificates of trust or beneficial interests (but see Rev. Rul. 2004-86)

Tenants-in-Common

- Rev. Proc. 2002-22.
- Key issue: TICs cannot be deemed partners in a partnership.
 - Must receive “rent” not participate in active business.
 - Must be tenants-in-common (“TIC”) under state law. Maximum 35 persons.
 - Must be “heads-up” deal (strictly % based, same % in all parcels). Debt must be pro-rata too.
 - May (should):
 - TICs execute an agreement (“TIC Agreement”) where TICs agree to meet requirements listed in Section 5 of Rev. Proc. 2002-22.
 - employ agent (“Property Manager”) under a property asset management agreement (“PAMA”) to manage the property.

Tenants-in-Common



- TICs execute TIC Agreement.
- TICs and Property Manager execute PAMA.
- Property Manager handles leasing to avoid TIC collective action problem.

Delaware Statutory Trust (“DST”)

Rev. Rul. 2004-86

Delaware Statutory Trust Act (12 Del.C. § 3801 et seq)

Logic: DST is a multi-beneficiary grantor investment trust, so beneficial interest (“BI”) holders treated as owning undivided interest in trust assets.

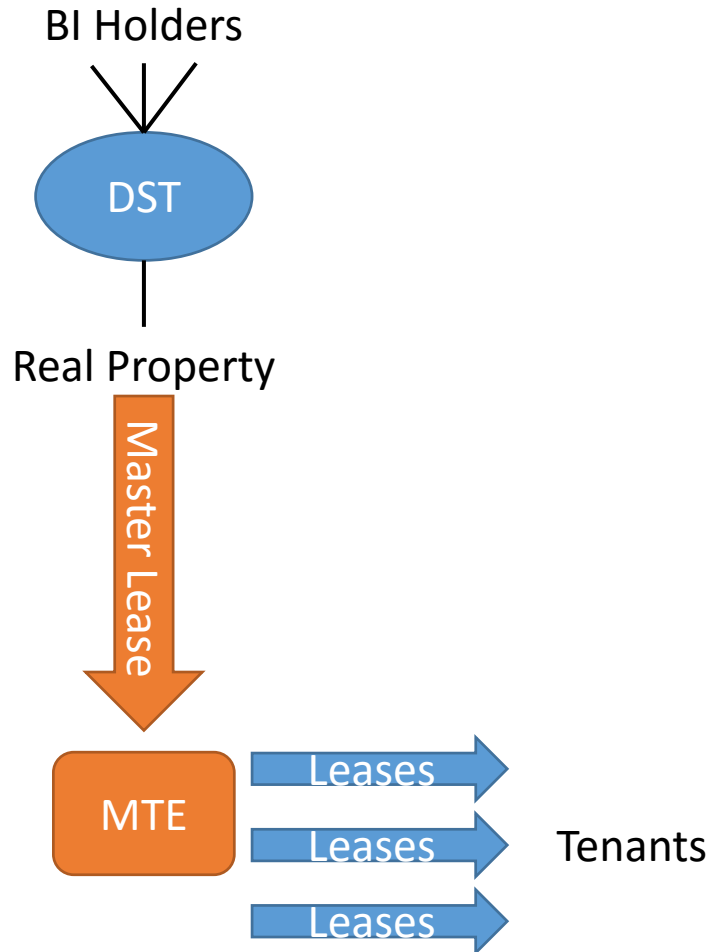
- “investment trust” under Treas. Reg. 301.7701-4(c) must:
 - Single class of beneficiaries,
 - Not have power to “vary the investment” of the trust, and
 - Be limited to “conserve and protect” trust property.
 - Contrast with “business trust” which is treated as business entity under check-the-box regulations. Treas. Reg. 301.7701-4(b).
- “grantor ... trust” means tax pass-through.
 - “Grantor” qualification under Subchapter J (IRC 667 et seq)
 - Contrast with “complex trust” which is a separate regarded taxpayer.
- Like TICs, must not be deemed a partnership.
- *Very* strict cash management rules to avoid temporary investment of cash “varying the investment”

“7 Deadly Sins” of DSTs

- The trustee cannot **dispose** of the trust’s property **and then acquire new** property (although the trustee can sell the trust’s assets and dissolve the trust).
- The trustee cannot enter into **new leases**.¹
- The trustee cannot **renegotiate a lease** with an existing tenant.¹
- The trustee cannot enter **new debt** encumbering the trust’s assets.
- The trustee cannot **renegotiate any existing debt**.
- The trustee cannot invest cash received to **profit from market fluctuations** (all cash must be investment in short-term Treasuries that will be distributed at the end of each calendar quarter).
- The trustee may not make **more than minor, non-structural modifications** to the trust’s property **not required by law**.

1. “except in the case of *[tenant’s]* bankruptcy or insolvency”

Usual DST Structure – the MTE



- DST owns real property but leases (“Master Lease”) to master tenant entity (“MTE”).
 - MTE ownership needs some difference from DST ownership to support master lease for tax purposes.
- MTE sub-leases to Tenants. It can do the “7 deadly sins” for itself.

(This also works in TIC deals as an alternate to a PAMA with a Property Manager.)

DST “Boot-Strapping”

Rev. Rul. 2004-86 spells out a specific story

- A purchased Blackacre
- The following occurs on the same day, in quick succession:
 - A net leases to Z (an MTE)
 - A contributes Blackacre to DST (DST assumes debt) in exchange for 100% of BIs
 - DST now essentially “frozen” avoiding 7 deadly sins
- A can then sell BIs to investors.
 - Under Rev. Rul. 2004-86, A is treated as selling undivided interests in Blackacre (i.e. long term capital gain more likely).
 - In syndicated deals, A is often a special purpose “depositor” entity to encapsulate liability from issuance.

The “Springing LLC”

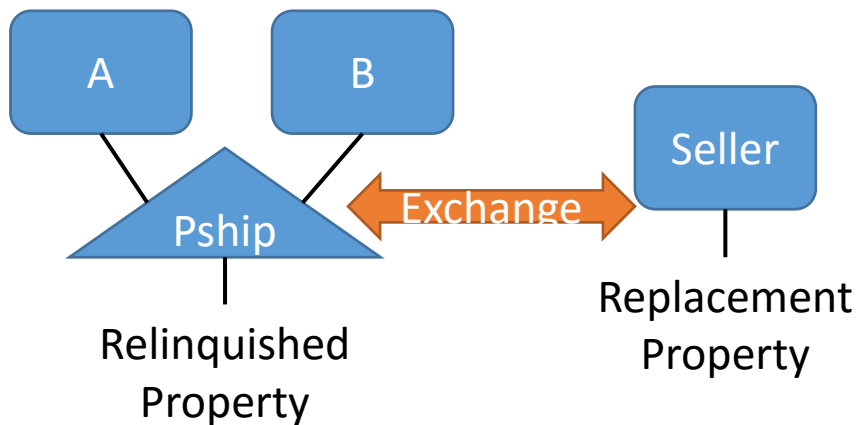
- A common lender concession is for the DST trust agreement to include a “springing LLC” provision.
- If the DST cannot remedy threats to the property (i.e. loan default) without violating the “7 deadly sins,” the DST converts to an LLC.
 - LLC receives all DST property and assumes all DST debt. DST terminates.
 - The LLC is now free to violate 7 deadly sins to “fix” the problem.
 - BI holders receive membership interests. These **do not** qualify for like-kind exchange treatment.
- This is not within Rev. Proc. 2004-86.
 - Is this a “power to vary the investment?”
Make it a mandatory spring under certain circumstances to limit this risk.
 - Can the LLC “spring back” to DST?

Special Issues Involving Partnerships

Coming and Going During an Exchange

- Technical terminations violate the “same taxpayer” requirement.
- IRC 708(b)(1)(B) Treas. Reg. 1.708-1(b)(2) 50% *or more* “capital and profits” is “sold or exchanged” within 12 months.
- Excluded from “sold or exchanged”:
 - “disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance” or
 - “the liquidation of a partnership interest”
 - Capital contributions of property (i.e. IRC 721 transactions)

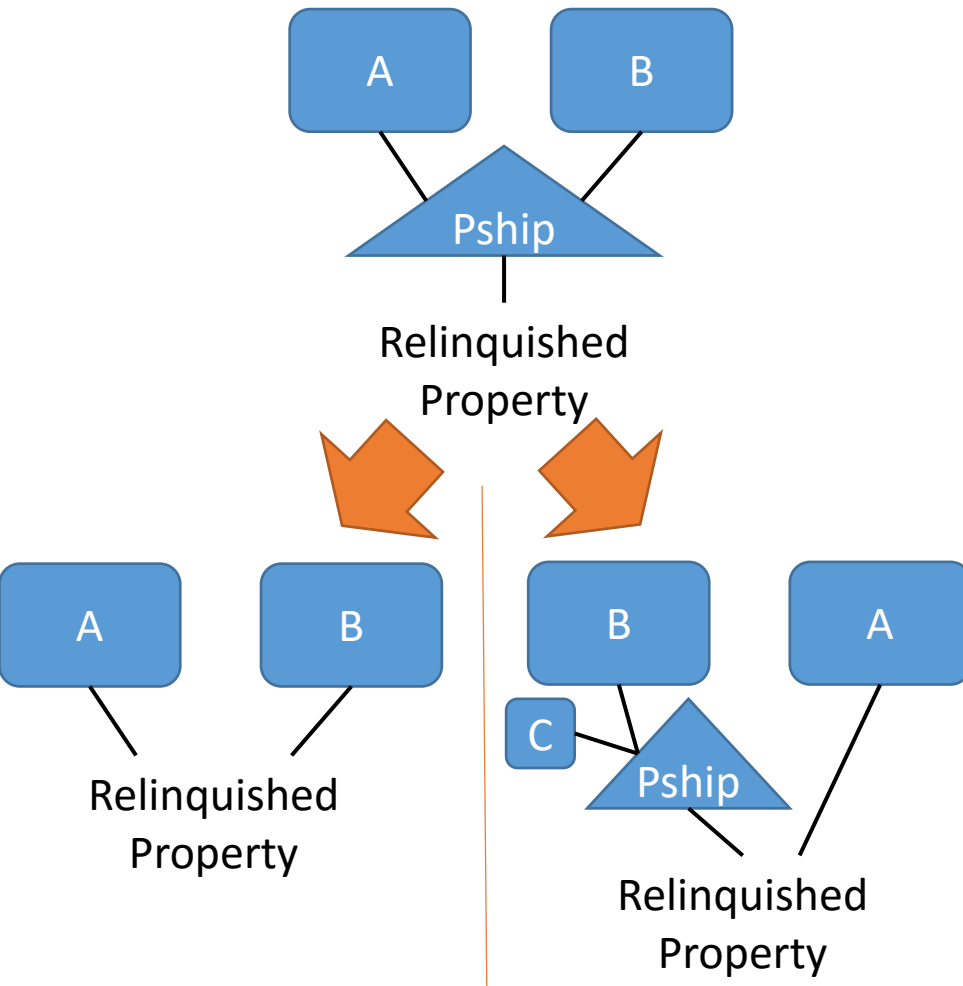
If A and B Want to Stay Together



- A&B (50/50 in Pship) want to stay together.
- Pship engages in the exchange.
- A&B must stay together
 - Pship technical terminations while the exchange are fatal to the exchange (“same taxpayer” problem”).
- Pship must cover all proceeds and replace all debt to avoid gain.

BUT WHAT IF A DOESN'T WANT TO STAY WITH B?

Drop-and-Swap Transactions



- Pship redeems A out for a share of the property.
 - Usually as TIC -- need to select a PM & execute TIC Agreement and PAMA.
 - Can use a DST as well.
- May need to admit new partner C (may be affiliate of B) to prevent Pship becoming disregarded.
- Buyer buys 50% from A and 50% from B/Pship.
 - Using a DST allows single seller
 - B/Pship does an exchange.
 - A takes cash and recognizes gain only on his 50% share.

Drop-and-Swap Limitations

- “Held for” issue – does B hold his interest in distributed property “for investment or productive use in a trade or business?”
 - IRS has frequently lost on this issue. *Magneson v. C.I.R.*, 81 T.C. 767 (1983) and *Bolker v. C.I.R.*, 81 T.C. 782 (1983).
- Step Transaction and the prohibition against exchanges of entities. If distribute from partnership immediately before exchange,
 - Did B exchange the property or the partnership interest?
 - Was A’s cash really Pship’s boot?
 - How long? There is no bright-line.

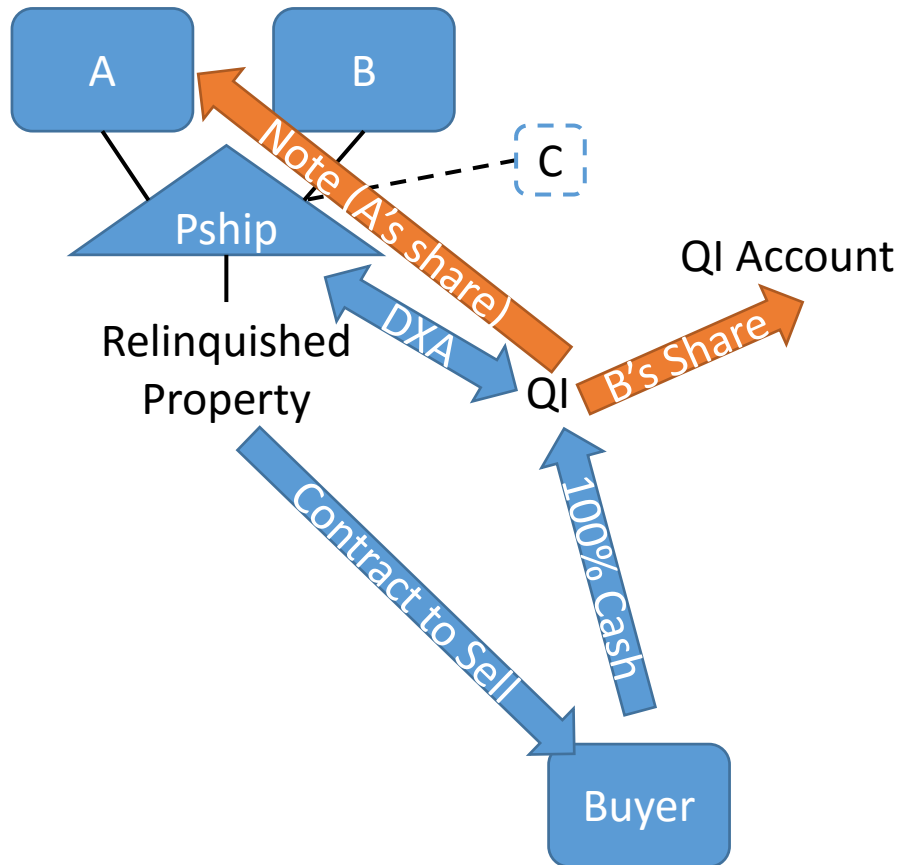
Concerns with the “Special Allocations” Method

Some counsel has the partnership sell, receiving boot for A’s share and allocating the gain to A before paying A the boot in redemption.

Problems:

- Gain is recognized to the extent of A’s share (boot cash)
 - A’s 50% share means 50% boot, which will realize that much gain. That is going to be more than A’s 50% share of gain (unless zero basis property).
 - Depreciation recapture (converts capital gain to ordinary income) attaches to the first gain recognized, so A will have a disproportionate share of recapture.
- A allocated all gain but only 50% of proceeds – does not seem to have “substantial economic effect” or follow the “partners’ interest in the partnership.”

“Partnership Installment Note” or “PIN” Transactions



- Pship prepares to sell the property in a deferred exchange.
- At closing, QI “pockets” A’s share of proceeds and issues Pship *installment note* for A’s share.
 - B’s share goes into QI account as normal.
 - Recall that QI is not Pship’s agent.
 - Installment note: at least one payment in next tax year. Qualifies Pship for installment method reporting under IRC 453 (must otherwise qualify).
- Pship redeems A for the Note.
- A receives A’s share as payments on Note.
- A realizes gain based on A’s basis in Pship interest.
 - IRC 1250 recapture (for Pship’s depreciation over straight-line) still applies.
- Pship must still cover all debt and spend all of QI account.

Thank you.

If you have questions:

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