

Wide (Sometimes Weird) World of 1031 Rulings and Cases

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**NANCY N. GREKIN**  
MCCORRISTON MILLER  
MUKAI MACKINNON  
HONOLULU, HAWAII  
ngrekin@hawaii.rr.com

**LOUIS S. WELLER**  
DELOITTE TAX LLP  
REAL ESTATE TAX SERVICES  
SAN FRANCISCO, CALIFORNIA  
lweller@deloitte.com

**ROBERT SCHACHAT**  
ERNST & YOUNG  
WASHINGTON, D.C.  
robert.schachat@ey.com

## TABLE OF CONTENTS

I.	EXCHANGES BY ENTITIES .....	1
	A. Transfer to Partnership Immediately Following an Exchange .....	1
	B. Transfer to Corporation Immediately Following an Exchange .....	1
	C. Exchanges by Corporations Following Dissolution .....	1
	D. Exchanges by Partnerships Immediately Following Dissolution .....	1
	E. Dissolution Immediately Following an Exchange .....	2
	F. Disregarded Entities.....	2
II.	RELATED PARTY EXCHANGES .....	2
	A. TAM 9748006.....	2
	B. TAM 20012600.....	2
	C. Rev Rul 2002-83 .....	3
	D. PLR 200251008 .....	3
	E. PLR 200440002 .....	3
	F. Teruya Brothers, Ltd v Comm’r .....	3
III.	REVERSE EXCHANGES.....	4
	A. Rev Proc 2000-37 .....	4
	B. Rev Proc 2004-51 .....	4
	C. PLR 200111025 .....	4
	D. PLR 200148042 .....	5
	E. DeCleene v Comm’r .....	5
	F. Field Office Announcement 20050203F .....	5
IV.	TENANCY IN COMMON INTERESTS.....	6
	A. Rev Proc 2002-22 .....	6
	B. Rev Proc 2004-86 .....	6
	C. PLRs 200327003, 200513010 and 200521002.....	7
V.	COORDINATION WITH CODE SEC .....	7
	A. Reg §§1.121(d), 1.121-1(e) and 1.121-1(e)(3) .....	7
	B. Rev Proc 2005-14 .....	7

## I. EXCHANGES BY ENTITIES

**A. Transfer to Partnership Immediately Following an Exchange.** *Magneson v. Comm'r*, 753 F2d 1490 (9th Cir. 1985). Taxpayers exchanged their interest in an apartment building for a partial interest in other commercial property and immediately contributed the replacement property to a partnership. The Service disallowed the exchange on the theory that the taxpayers did not hold the replacement property for investment after acquisition but intended to transfer it to the partnership. The Tax Court ruled that because a partnership, unlike a corporation, is not an entity distinct from its partners, the partners are treated as owning the assets of the partnership. The investment in the new property was held to be a continuation of the old investment, still unliquidated, and the taxpayers were treated as holding the property for investment notwithstanding transfer to a partnership.

**B. Transfer to Corporation Immediately Following an Exchange.** *Regals Realty Co. v. Comm'r*, 127 F2d 931 (2d Cir. 1942); accord, Rev. Rul. 75-292, 1975-2 CB 333. Taxpayer immediately contributed property received in an exchange to a corporation he controlled. The Tax Court and the Service held that the taxpayer did not acquire the property for investment because of the immediate transfer to the corporation in exchange for stock viewing the change of the form of ownership as having been a transfer which demonstrated that the taxpayer lacked investment intent at the time of acquisition of the property in the exchange.

### C. Exchanges by Corporations Following Dissolution.

1. Rev. Rul. 77-337. Taxpayer transferred property to its shareholder in a tax-free liquidation under former Code Sec. 333 immediately prior to the exchange by the taxpayer of the property. The Service disallowed the exchange, holding that the taxpayer failed to meet the qualified use test.

2. *Bolker v. Comm'r*, 760 F2d 1039 (9th Cir. 1985). Facts were identical to the facts in Rev. Rul. 77-337 but the court distinguished the Revenue Ruling because in *Bolker* the corporate liquidation was apparently planned before the taxpayer decided to exchange and he held the property for three months prior to the exchange.

3. *Commissioner of Int. Rev. v. Court Holding Co.*, 65 S.Ct. 707 (1945). Taxpayers sold property received from a corporation of which they were the shareholders following a tax-free corporate liquidation. The corporation had entered into an agreement to sell the property prior to the liquidation, the sale was imminent, and the contract to sell the property was assumed by the shareholders. The Supreme Court, upholding the Tax Court, disallowed the exchange, collapsing the liquidating distribution, and held that the corporation had not abandoned the sale of the property and that the liquidation was a “mere formality . . . designed to make the transaction appear to be other than it was.”

4. TAM 9645005. Partner in a joint venture cannot defer gain on the condemnation of property when the property was not distributed to the partner until one day before the condemnation sale's closing

**D. Exchanges by Partnerships Immediately Following Dissolution.** *Mason v. Comm'r*, 55 TCM 1134 (1988). Taxpayer was partner in several partnerships that owned real

estate. The partners decided to liquidate two of the partnerships, and to then exchange certain properties received in the liquidation. The Tax Court held that the liquidation under Code Sec. 731 followed by the exchange qualified as an exchange. The taxpayer in *Mason* apparently intended to exchange the property before completing the liquidation but did not enter into an agreement to do so until after the liquidation.

**E. Dissolution Immediately Following an Exchange.** *Maloney v. Comm'r*, 93 TC 89, (1989). Corporation exchanged and immediately liquidated the corporation under now repealed Code Sec. 333 distributing the property to the shareholders. The Service disallowed alleging that the corporate taxpayer which exchanged did not hold the replacement property for investment but conceded that, but for the corporate liquidation, the transaction would have qualified under Code Sec. 1031. Citing *Bolker*, the Tax Court approved the exchange holding that the intent of the corporation to liquidate did not impair its investment intent as to the replacement property, that the corporation's intent would be imputed to its shareholder, and that the liquidation did not impair the corporation's continuing economic interest in the same investment.

**F. Disregarded Entities.** PLRs 9751012, 9807013, 9850001, 199911033, 200118023 and 200131014. Taxpayer may take title to the replacement property in a disregarded entity.

## II. RELATED PARTY EXCHANGES

**A. TAM 9748006.** Taxpayer sold relinquished property to an unrelated third party, and acquired replacement property from his mother. The taxpayer and his mother both owned an interest in the relinquished property, which they sold to an unrelated third party. The taxpayer's mother did not exchange but used the proceeds to acquire a principal residence. The taxpayer did exchange and entered into negotiations to purchase a replacement property from an unrelated third party but those negotiations failed, and the designation period was expiring, so the taxpayer designated and acquired the residential property from his mother as his replacement property. The Service disallowed the exchange under Code Sec. 1031(f)(4) because "the taxpayer disposed of [the relinquished property] through a qualified intermediary and through the same qualified intermediary acquired [the replacement property] from Related Party. The economic result of this series of transactions is identical to what would have occurred in a direct exchange of property." The Service also noted that the mother had cashed out of her high basis property thus recognizing little gain and thus there was basis shifting.

**B. TAM 20012600.** The taxpayer which was the subject of this TAM was Teruya, the taxpayer in the Tax Court case described in Section F below. The taxpayer sold three investment properties in two separate transactions to unrelated third parties, and purchased replacement properties from a related party. Again the Service ruled that the transactions were structured to avoid the application of Code Sec. 1031(f) and disallowed them under Code Sec. 1031(f)(4). The Service determined that "cashing out" had occurred because the related party seller used the cash resulting from the sale to the taxpayer to reduce its debt. In this ruling the Service viewed the exchange as not being subject to Section 1031(f) because it noted "the application of that section is limited to circumstances that involve a direct or indirect related party exchange." Again the Service viewed the transaction as having violated subsection (f)(4)

because the exchanging party used an accommodator. Further, it appears that (i) the Service defines the taxpayer carrying over low basis to property acquired from a related party as abusive basis shifting, and (ii) treats the use of the exchange funds by the related party seller to pay down debt as “cashing out” by the taxpayer.

**C. Rev Rul 2002-83.** Disallowed an exchange in which replacement property was acquired from a related party under Code Sec. 1031(f)(4) because the taxpayer has as an attempt to avoid the related party rules by transacting with an intermediary.

**D. PLR 200251008.** PLR 200251008 involved a reverse build-to-suit exchange. A limited liability company which was a related party to the taxpayer transferred leasehold property to a QEAT which constructed the improvements on the property. The QEAT was a single-member limited liability company. Upon completion of the improvements, the membership interest in the QEAT was transferred to the taxpayer. The Service characterized the exchange as a “parking transaction between related parties” yet it ruled that “§1031(f)(1) is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that was part of the exchange.”

**E. PLR 200440002.** Two related taxpayers exchanged, one acquiring the relinquished property of the other as its replacement property, and the other acquiring replacement property from an unrelated third party. A qualified intermediary was used in both exchanges. After analysis of Rev. Rul. 2002-83, the Service ruled that related parties can exchange without precluding non-recognition under Code Sec. 1031(f)(4) even if a qualified intermediary is used in the exchange, so long as neither related party “cashes out” of their real estate investment. No “cashing out” occurs, the Service ruled, if both related parties exchange.

**F. Teruya Brothers, Ltd v Comm’r, 124 T C No 4 (2005).** This is the taxpayer in TAM 20012600 described in Section B above. The Service argued that the taxpayer had run afoul of Code Sec. 1031(f)(4) and in its discussion and reasoning, the Court analyzed only the question of whether a transfer to an intermediary of the replacement property constituted the type of transfer contemplated by the legislative history of Code Sec. 1031(f)(4).

The Court discussed the legislative history of Code Sec. 1031(f)(1) and its theory that if related parties exchange either can “cash out” of the property acquired “at little or no tax cost” or “accelerate a loss” on property retained through basis shifting. It was these perceived abuses which is reflected in the two-year holding period imposed by Code Sec. 1031(f)(1). The Court then analyzed the legislative history of Code Sec. 1031(f)(4) which was to prevent taxpayers from circumventing the purposes of the two-year rule. The Service argued that the qualified intermediary should be equated with the “unrelated party” referred to in the legislative history of Section 1031(f)(4), and that in the view of the Service, the transaction should therefore be recast as a direct exchange between the related parties because if Code Sec. 1031(f)(1) would preclude exchange treatment, then the exchange should be deemed to have been structured to avoid it, and that in the view of the Service this result should end the analysis under Code Sec. 1031(f)(4). The Court rejected this theory as having only “superficial appeal.” If the Court had adopted it *per se*, it would have required that the Court in fact recharacterize the structure of the transaction and treat the taxpayer as having made a transfer which did not occur.

Rather the Court noted that the analysis failed to consider the non-tax avoidance exception contained in Code Sec. 1031(f)(2)(C), one of the three exceptions to disposition of exchanged property during the two-year holding period. The Court's reason for concluding that the exception is applicable to Code Sec. 1031(f)(4) was that the Code provides that a transaction is disallowed if it "is structured to avoid the purposes of this subsection [Section 1031(f)]" and the Court ruled that the exception is "subsumed within the purposes of section 1031(f)" so it should be considered. The Petitioner argued that there was no intent to disguise an actual sale because it never intended to sell but rather only to exchange. The Court rejected this argument holding that the economic substance of the transactions was that the related party seller of the replacement property "cashed out" and "ended up with the sales proceeds" and further noted that the "interposition of a qualified intermediary in these transactions cannot obscure the end result." The Court's final note was that the taxpayer "offers no explanation for structuring the . . . transactions as it did, and the record disclosed no reason (other than seeking to avoid the section 1031(f) rules) for . . . using a qualified intermediary to accomplish he transactions."

### **III. REVERSE EXCHANGES**

**A. Rev Proc 2000-37.** Safe harbor for structuring related party exchanges.

**B. Rev Proc 2004-51.** Modified Rev. Proc.2000-37 by deleting the provision stating that if the safe harbor is followed the Service will not challenge the parked properties as replacement or relinquished properties, and substituting a statement the Service will treat an EAT as the beneficial owner of property for federal income tax purposes if the property is held in a "qualified exchange accommodation arrangement" as defined in Revenue Procedure 2000-37. This was done because the Service believed that the non-challenge language precluded taxpayers from having to demonstrate whether the qualified exchange accommodation titleholder held the benefits and burdens of ownership and taxpayers interpreted this to mean that they could transfer replacement property to a qualified exchange accommodation titleholder (in build to suit exchanges) and receive back the same property as replacement property thus shifting bases between two properties. A new section was added to Revenue Procedure 2000-37 specifically confirming this. The new section provides that it does not apply to replacement property held in a qualified exchange accommodation arrangement if the property was owned by the taxpayer within the 180-day period ending on the date of transfer.

**C. PLR 200111025.** Real estate business's reverse multi-party exchange of parkland/rental-investment property for rental real property qualified under 1031, despite inapplicability of Reg. §1.1031(k)-1 or Rev. Proc. 2000-37, 2000-40 IRB 308's safe harbor relief: inclusion of "tax-deferred exchange cooperation provisions" in option and acquisition agreements reflected taxpayer's consistent intent to effect Code Sec. 1031; qualified exchange. Properties were like-kind and held for qualified use, multi-step transactions involving unrelated accommodation party were part of integrated exchange plan, and accommodation party wasn't taxpayer's agent, based on Supreme Court agency analysis and other case law, which established that mere use of accommodator in like-kind exchange didn't necessarily mean accommodator was agent.

**D. PLR 200148042.** Statement in qualified exchange accommodation agreement authorizing LLC as customer's agent for everything except income tax purposes won't affect QEA or its qualified status under Rev. Proc. 2000-37.

**E. DeCleene v Comm'r, 115 TC 457, CCH Dec. 54,128 (2000).** Taxpayer owned property used in his trade or business. He wanted to move the location of the business and he located property that he acquired in part with a bank loan. After acquiring the new property, an interested buyer made an offer to buy the existing property and taxpayer's accountant suggested a 1031 exchange structured by having the taxpayer quitclaim the new property to the buyer who constructed a building on the new property, then exchanged it with the taxpayer for the existing business property. The Tax Court noted that this exchange was not subject to the reverse exchange revenue procedure because it occurred prior to its issuance, so it looked to "general principles of tax law" in deciding the case. The court held first that the buyer who acquired the property from the taxpayer did not have an economic interest in the replacement property because he paid for the property with a non-recourse note due in a single payment, and paid the construction costs with a non-recourse loan from the exchanging party's bank. The parties treated the ownership by the buyer of the replacement property as having no economic significance because of the non-recourse debt and the fact that the buyer had no liability even for property taxes. Because the taxpayer made no effort to structure the parking arrangement as a reverse exchange, with the economic burdens and benefits of ownership in the replacement property vested in the buyer/accommodator, the transaction was disallowed.

**F. Field Office Announcement 20050203F.** Taxpayer attempted a reverse exchange which occurred prior to issuance of Rev. Proc. 2000-37, although this was announced several years following its issuance. The Service ruled that the taxpayer did not have the benefit of the Rev. Proc. because the exchange occurred prior to its issuance, but even if the exchange had occurred after issuance of the Rev. Proc. the taxpayer failed to comply with it. Taxpayer contracted with a QEAT to purchase replacement property but it appears that the taxpayer borrowed the purchase price, and had the loan funds paid directly to the seller rather than documenting a loan transaction between the taxpayer and the QEAT. Following acquisition, the QEAT leased the property to the taxpayer for a term of 24 months with options to extend and agreed to construct improvements on it. The lease was a net lease, requiring the taxpayer to pay all property taxes and insurance costs. The purchase price of the property to be paid by the taxpayer in its forward exchange was the acquisition cost during the first twenty-four months following acquisition by the QEAT; thereafter the purchase price was its fair market value as determined by appraisal. The Service ruled that the exchange did not qualify as a reverse exchange analyzing the facts in light of the Rev. Proc. and noted that the following factors are considered in determining whether a QEAT has beneficial ownership of the property:

- whether legal title passes;
- whether the parties treat the transaction as a sale;
- whether the QEAT acquires an equity interest in the property;
- whether the sales contract creates an obligation on the part of the seller to execute and deliver a deed and an obligation on the purchaser to make payments;

- whether the QEAT is vested with the right of possession;
- whether the QEAT pays income and property taxes;
- whether the QEAT bears the risk of economic loss or physical damage; and
- whether the QEAT receives a profit from the operation, retention and sale of the property.

The Service listed the following factors in the qualified exchange accommodation agreement of this taxpayer as significant in determining whether the QEAT held the benefits and burdens of ownership:

- whether legal title had passed to the QEAT.
- whether the QEAT acquired an equity interest in the property.
- whether the contract for purchase of the replacement property obligated the seller to execute and deliver a deed and obligated the QEAT to make payments.
- whether the QEAT is vested with the right of possession.
- whether the QEAT pays property taxes after the transaction.

#### **IV. TENANCY IN COMMON INTERESTS**

**A. Rev Proc 2002-22.** Safe harbor describing necessary requirements to obtain a private letter ruling as to whether a tenancy in common arrangement qualifies.

**B. Rev Proc 2004-86.** Taxpayer acquired as the replacement property in the exchange, an interest in a Delaware statutory trust which owed real estate. A Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners which is created by executing a governing instrument and filing an executed certificate of trust. Property in the trust is shielded from creditors of the beneficial owners. A Delaware statutory trust may sue or be sued, and property held in a Delaware statutory trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a Delaware statutory trust are entitled to the same limitation on personal liability extended to stockholders of Delaware corporations. Notwithstanding its entity status, a taxpayer who owns an undivided fractional interest in such a trust is treated as owning the trust assets attributable to that undivided fractional interest for federal income tax purposes.

Under the trust agreement in this Rev. Ruling, the trustee's activities were limited to the collection and distribution of income; it could not exchange the property owned by the trust for other property, purchase assets other than the short-term investments, or accept additional contributions of assets (including money) to the trust. The trustee could not renegotiate the terms of the debt used to acquire the property, could not renegotiate the lease with the tenant of the property or enter into leases with other tenants, and could make only minor non-structural modifications to property held in the trust.

The Service ruled that because the trustee had none of the powers which evidence an intent to carry on a profit-making business, all of the interests in the trust were of a single class representing undivided beneficial interests in the assets of the trust, and the trustee had no power to vary the investment of the beneficiaries to benefit from variations in the market, therefore the trust was classified as a trust under Reg. § 301.7701-4(c)(1). It ruled further that the exchanging parties would be treated as grantors of the trust under Reg. § 1.671-2(e)(3) when they acquired their interests in the trust and because they had the right to distributions of all trust income attributable to their undivided fractional interests in the trust, were each treated, by reason of Code Sec. 677, as the owner of an aliquot portion of the trust and all income, deductions, and credits attributable to that portion would be included in their taxable income. Because the owner of an undivided fractional interest of a Delaware statutory trust is treated as owning the trust assets attributable to that interest for federal income tax purposes, the exchanging parties were treated as having acquired an interest in the real estate owned by the trust, and the exchange was allowed.

**C. PLRs 200327003, 200513010 and 200521002.** Rulings on qualification of tenancy in common arrangements.

## **V. COORDINATION WITH CODE SEC. 121**

**A. Reg. §§1.121(d), 1.121-1(e) and 1.121-1(e)(3).** Code Sec. 121 does not apply to gain allocable to any portion of the property which does not satisfy the residential use requirement and is located in a building which is separate from the residential property. The taxpayer can exclude the gain on the sale of that portion of the property which is used for business purposes under 1031 but 1031 does not apply to depreciation deductions taken after May 6, 1997 so the taxpayer will recapture the depreciation and recognize the gain attributable to such depreciation deductions at the time of sale. When gain is recognized under Code Sec. 121 due to recapture of depreciation to determine the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same pro rata allocation that the taxpayer used to determine depreciation deductions. Three issues were left open by the Code Sec. 121 Regulations:

- Can a taxpayer defer recognition of recaptured depreciation in a Code Sec. 1031 exchange?
- Can a taxpayer exchange the portion of the property in a separate building used for business or investment purposes?
- Can a taxpayer elect to exchange that portion of the property used for business or investment purposes within the dwelling rather than exempting the gain on such portion under Code Sec. 121.

Rev. Proc. 2005-14 resolves the issues left open by Code Sec. 121 and the Code Sec. 121 Regulations.

**B. Rev Proc 2005-14.** The Service adopted rules similar to Code Sec. 121(d)(5)(B) which provides the rules for application of Code Sec. 121 to another non-recognition provision, Code Sec. 1033. The Revenue Procedure provides as follows:

- Taxpayers may apply both the exclusion of gain from the exchange of a principal residence under Code Sec. 121 and Code Sec. 1031 to an exchange of relinquished property which qualifies for exchange under Code Sec. 1031. Realized gain may be deferred under Code Sec. 1031 whether the relinquished property is located in the same building as the dwelling or in a separate building.
- The relinquished property sold must satisfy both the requirements for exclusion of gain from the exchange of a principal residence under Code Sec. 121 and the qualified use test of Code Sec. 1031.
- Code Sec. 121 is first applied to gain realized before applying Code Sec. 1031 with respect to relinquished property located within the dwelling. Gain realized up to the amount which may be excluded under Code Sec. 121 will reduce the realized gain which must be deferred in the exchange, but will not be applied to reduce gain realized by recapture of depreciation.
- Depreciation recaptured under Code Sec. 121(d)(6) may be deferred under Code Sec. 1031. The taxpayer is treated as having realized the recaptured depreciation, but if he acquires replacement property equal in value to the amount realized by recaptured depreciation it will be deferred in the exchange.
- The *Poague* (*Poague v. U.S.*, 66 AFTR 2d 90-5825 (E.D. Va. 1990) in which a taxpayer exchanged mixed use property and the Court held under old Section 1034 that he could not use that portion of the proceeds attributable to the business property to acquisition of replacement residential property) test which allocates realized gain in the same proportion as the relative square footages of the residential and investment or business portions of the property is adopted as an appropriate method of allocating the basis and the amount realized to the residential and investment or business portions of the relinquished property.
- The taxpayer's basis in the replacement property is his adjusted basis in the relinquished property, increased by any gain excluded under Code Sec. 121 as to the investment or business portion of the property, and decreased by any boot received, even if not recognized as boot in the exchange due to the application of Code Sec. 121.

In applying Code Sec. 1031 boot received in the exchange is recognized only to the extent it exceeds the gain excluded under Code Sec. 121 with respect to the investment or business portion of the relinquished property.