
In a landmark decision, Tax Court holds that a non-safe-harbor reverse like-kind exchange qualifies for nonrecognition treatment under Section 1031

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In brief

The US Tax Court, in a long-awaited decision released August 10, has held that a non-safe-harbor reverse like-kind exchange (LKE) transaction qualifies for nonrecognition treatment under Section 1031. In *Estate of George H. Bartell, Jr. v. Commissioner*, 147 T.C. No. 5 (2016), the Tax Court rejected the IRS's argument that an 'exchange accommodation titleholder' (EAT) must acquire the traditional benefits and burdens of ownership of the property to facilitate a Section 1031 exchange.

Although it is unclear whether the IRS will appeal the decision, the decision could be helpful for taxpayers contemplating non-safe-harbor reverse LKEs while reducing the risks normally associated with such transactions.

In detail

Background

Section 1031 generally provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment for property of a like kind to be held for productive use in a trade or business or for investment. The idea behind Section 1031 is that when upgrading or reinvesting in trade or business property, taxpayers generally do not cash out their investment, so it is

appropriate that neither losses nor gains are recognized. The rationale for nonrecognition in a LKE is that the newly acquired property is a continuation of the old investment, which remains unliquidated. The new property is viewed as a change in form, but not in substance, of the investment.

While Section 1031(a)(3), which provided for deferred exchanges, and its corresponding regulations eased some of the practical challenges faced by taxpayers seeking to

accomplish LKEs, several difficulties remained. In particular, taxpayers that needed to acquire replacement property prior to the transfer of the relinquished property, commonly referred to as 'reverse exchanges,' had little guidance when structuring their exchange transactions. Taxpayers often used so-called 'parking' transactions to facilitate both reverse exchanges and the construction of improvements in a LKE. Rev. Proc. 2000-37 provided a safe

harbor for accomplishing both reverse and build-to-suit exchanges.

Rev. Proc. 2000-37 specifically provides that a taxpayer may ‘park’ a replacement property for up to 180 days with an EAT prior to a sale transaction. Under the safe harbor, the IRS treats the EAT as the beneficial owner of the property for federal income tax purposes if the property is held in a ‘qualified exchange accommodation arrangement’ and meets certain requirements enumerated in the revenue procedure, including that the EAT must acquire a qualified indicia of ownership — which can be bare legal title — in the parked property.

Rev. Proc. 2000-37 permits a taxpayer to have significant involvement with the replacement property during the interim period, including providing or guaranteeing a loan to acquire the property, leasing the property, supervising construction, or acting as a contractor. Under the safe harbor, the EAT does not need to have risk of loss, an equity investment, or other traditional benefits and burdens of ownership. However, the safe harbor requires the relinquished property to be identified within 45 days and the parking arrangement to be completed within 180 days.

Observation: The 180-day time limit in Rev. Proc. 2000-37 made it impractical for many exchanges in which substantial improvements needed to be made to the replacement property.

Facts in ‘Bartell’

In 1999 the taxpayer, a drugstore chain, entered into an agreement to purchase property in Lynnwood, Washington (the replacement property). The taxpayer had intended to enter into a LKE transaction pursuant to Section 1031 to facilitate the acquisition of the replacement

property. In anticipation of the exchange transaction, the taxpayer entered into a second agreement with an EAT. The EAT agreed to acquire title to the replacement property to facilitate the LKE.

As part of the exchange transaction and in accordance with its agreement with the taxpayer, the EAT obtained financing from a bank to purchase the replacement property and construct a new drugstore. The bank loan was guaranteed by the taxpayer. Further, the taxpayer’s agreement with the EAT allowed the taxpayer to manage construction of the new drugstore and lease the improved replacement property from the EAT once construction was completed. While the taxpayer’s option to purchase the replacement property was for fair market value, for the first 24 months, fair market value was fixed at the EAT’s cost. The EAT closed on the replacement property on August 1, 2000.

Although construction had been completed on the replacement property, several developments delayed the sale of the taxpayer’s existing property in Everett, Washington (the relinquished property). Finally, in September 2001, the taxpayer entered into a contract to sell the relinquished property. The sale of the relinquished property and the acquisition of the replacement property were structured as is typical for an exchange facilitated by a qualified intermediary under Reg. sec. 1.1031(k)-1(g)(4). On December 31, 2001, the EAT transferred title of the replacement property to the taxpayer. The LKE was completed long after the 180-day safe harbor allowed under Rev. Proc. 2000-37 would have expired (although, as the court noted, the revenue procedure did not apply to the transaction).

Observation: Except for the 17-month time period, the transaction was structured in a manner that is substantially similar to what is sanctioned in Rev. Proc. 2000-37.

The taxpayer subsequently filed with the IRS its 2001 Form 1120S, *U.S. Income Tax Return for an S Corporation*, along with Form 8824, *Like-Kind Exchanges*, which addressed the transfers of the Everett and Lynnwood properties. The taxpayer’s shareholders prepared and filed corresponding Schedules K-1, *Shareholder’s Share of Income, Credits, Deductions, etc.* In early 2004, the IRS commenced an examination of the taxpayer’s 2001 corporate income tax return, and issued Form 5701, *Notice of Proposed Adjustment*, and corresponding Form 886A, *Explanation of Items*. The adjustment proposed the disallowance of tax-deferral treatment under Section 1031 for the transfers of the Everett and Lynnwood properties. The taxpayer petitioned the Tax Court and the case was tried in 2006.

The principal issue before the court was whether the taxpayer had been the true owner of the replacement property prior to the sale of the relinquished property, thus placing the exchange transaction outside the purview of Section 1031.

The parties’ arguments

IRS argument

The IRS asserted that the taxpayer’s transaction failed to qualify as an exchange for purposes of Section 1031 because the taxpayer in fact was the owner of the replacement property purportedly received. The IRS argued that a ‘benefits and burdens’ test should be used to determine whether the taxpayer was the true owner of the replacement property. The IRS stated that because the taxpayer had “the capacity to benefit from any

appreciation in the property's value, the risk of loss from any diminution in its value, and the other burdens of ownership," the taxpayer, not the EAT, was the actual owner of the replacement property at the time of the exchange.

The IRS contended that the Tax Court had applied the 'benefits and burdens' test to a reverse exchange in *DeCleene v. Commissioner*, 115 T.C. 457 (2000), in which it held that a taxpayer failed to qualify for Section 1031 treatment because "taxpayer cannot engage in an exchange with himself." The IRS therefore argued in *Bartell* that the taxpayer's transaction did not qualify as a LKE under Section 1031 because the taxpayer similarly had effected a 'self-exchange.'

Taxpayer's argument

The taxpayer contended that the transaction was properly treated as a LKE, thus permitting deferral of income under Section 1031. The taxpayer argued that case law in both the Tax Court and the Ninth Circuit, to which an appeal would ordinarily lie, had previously rejected the argument that an EAT that takes title to a replacement property solely for purposes of effecting a Section 1031 exchange must assume the traditional benefits and burdens of ownership in the property to satisfy the exchange requirement, as the IRS suggested.

The taxpayer pointed to the Ninth Circuit decision in *Alderson v. Commissioner*, 317 F.2d 790 at 795 (1963), in which the appellate court stated that "one need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title solely for the purpose of exchange and accept title and transfer it in exchange for other like property, all as a part of the same transaction with no resulting gain which is recognizable under Section

1002 of the Internal Revenue Code of 1954." The taxpayer argued that the Tax Court should apply an agency analysis that is consistent with the broad latitude historically permitted in the context of LKEs.

Tax Court opinion

The Tax Court rejected the IRS argument that a 'benefits and burdens' test should be applied in the current case. The court distinguished the facts in *DeCleene* from the facts of the current case, pointing out that the taxpayer in *DeCleene* had failed to use a third-party exchange facilitator. According to the court, "*DeCleene* did not address the circumstances where a third-party exchange facilitator is used from the outset in a reverse exchange. Moreover, the taxpayer in *DeCleene* had acquired the purported replacement property outright, and held title to it directly without any title-holding intermediary, for more than a year before transferring title..."

The Tax Court noted that case law has established that "where a section 1031 exchange is contemplated from the outset and a third-party exchange facilitator, rather than the taxpayer, takes title to the replacement property before the exchange, the exchange facilitator need not assume the benefits and burdens of ownership of the replacement property in order to be treated as its owner for section 1031 purposes before the exchange."

The *Bartell* transaction occurred in 2000, but predated the effective date of Rev. Proc. 2000-37. The Tax Court suggested that because the taxpayer undertook the exchange transaction prior to Rev. Proc. 2000-37, the transaction was structured without knowledge of the revenue procedure. Thus, the revenue procedure, including the 45- and 180-day periods in which the taxpayer must identify the replacement property and receive

it, respectively, could not be applied in this case.

The Tax Court held that the taxpayer's disposition of the relinquished property and acquisition of the replacement property qualified for non-recognition treatment pursuant to Section 1031.

The takeaway

The decision in *Bartell*, which LKE practitioners have been awaiting for 10 years, represents one of the most important LKE developments in many years. Most importantly, the Tax Court emphasized that when a third-party accommodator acquires the replacement property, it is not necessary for the accommodator to have the traditional benefits and burdens of ownership.

Although it is unclear whether the IRS will appeal the Tax Court's ruling in *Bartell*, the fact that the appeal would be to the Ninth Circuit, where there is taxpayer-favorable precedent, could affect the IRS's decision. Further, having set forth the safe harbors in Rev. Proc. 2000-37, the IRS may not believe it needs to further litigate. However, the risk that the case will be appealed or that the IRS will take other action to limit the taxpayer-favorable decision cannot be discounted. It is also possible that Treasury will seek legislation limiting the time periods for reverse LKEs (as it did for deferred exchanges following the *Starker* decision in 1979).

Nevertheless, pending further developments, taxpayers may wish to take this favorable decision into account in engaging in non-safe-harbor LKEs that exceed the time periods set forth in Rev. Proc. 2000-37. This will be particularly important for transactions in which substantial construction is required to be made on the replacement property.

Taxpayers should consult with their tax professionals to structure their transactions as closely as possible to

the facts in *Bartell*. That said, there likely will be a substantial increase in

the use of non-safe-harbor exchanges in the near future.

Let's talk

For a deeper understanding of how these issues might affect your business, please reach out to one of the PwC professionals listed below:

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