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TRENDS IN REAL ESTATE AND TITLE INSURANCE

Section 1031 to the Rescue?

The 'like-kind exchange' tax deferral mechanism may not always be the prudent choice.

BY ROGER M. ROISMAN AND DAVID SCHULDER

IN RECENT YEARS, the availability and use of the "like-kind exchange" tax deferral mechanism has increased dramatically, primarily because of a continuing and dramatic increase in real estate prices throughout the United States. With the reduced value of the dollar in world markets and low interest rates, American real estate has become a bargain for overseas investors and attractive for private equity and opportunity funds looking for alternative investments.

Traditional valuation standards have given way to the acceptance of lower returns on investments in real estate and, thus, higher pricing. We now have a booming seller's market where underwriting and due diligence standards are often relaxed in property acquisitions. This higher pricing has created greater incentives to sellers, thanks to prices unimagined just a few years ago.

These higher prices produce larger gains and greater taxes, thus creating a greater focus on the income tax deferral benefits of like-kind exchanges pursuant to §1031 of the Internal Revenue Code of 1986, as amended (Code).

A large number of real estate and tax consultants have formulated programs intended to simplify the acquisition of properties to be used as part of like-kind exchanges. Some of these programs have economic and tax risk, while others are more conservative.

Roger M. Roisman *is a real estate partner, and* **David Schulder** *is a tax partner, with Tannenbaum Helpern Syracuse & Hirschtritt. Tax associate* **Michelle Gibbs** *assisted in the preparation of this article.*

This article discusses the requirements and dangers of §1031 of the Code. In addition to its technical requirements, consideration is given to the following factors:

(1) With historically low capital gains tax rates, this may not be a bad time to recognize the "gain," pay the tax and move on to something else.

(2) Replacement properties are expensive — their economic attributes must be studied and compared to the property being sold.

(3) Transactional expenses for both the sale and the purchase of replacement property, including transfer taxes, title insurance, financing fees, brokerage commissions and attorney's fees, are meaningful factors to be considered in evaluating the benefits of a like-kind exchange.

Basics of a 1031 Exchange

Section 1031 of the Code provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for "like-kind" property.

Gain realized on a §1031 exchange must be recognized to the extent (a) of the sum of any money (including liabilities assumed or attaching to the property) received and the fair market value of non-qualifying property received in the exchange ("boot") and (b) that any of the gain realized is subject to the recapture provisions under the Code.[1] No loss is ever realized on a §1031 exchange.[2]

While §1031 allows for the deferral of the tax on the gain on property transferred in the exchange ("relinquished property"), it preserves the gain by providing that the basis of property acquired in the exchange ("replacement property") is the same as the basis of the relinquished property, decreased by the amount of any money received and increased by the amount of any gain recognized in the exchange.[3]

The Code permits deferred (forward), nonsimultaneous exchanges that qualify under §1031 in certain circumstances.

In order to qualify as a like-kind exchange, the taxpayer has 45 days from the date it transfers the relinquished property to identify replacement properties, and until the earlier of (a) 180 days from such date of transfer or (b) the due date for the taxpayer's tax return for the taxable year in which the acquisition of the relinquished property occurs, to close on the acquisition of the replacement properties.[4]

A taxpayer may identify as replacement properties any three properties or multiple properties with an aggregate fair market value not exceeding 200 percent of the aggregate fair market value of all the

relinquished properties.[5] A qualified escrow account, a qualified intermediary or certain other arrangements may be used by a taxpayer under the Treasury Regulations issued under §1031 (1031 Regulations) to facilitate a deferred exchange,[6] an arrangement typically provided by a title insurance company.

Leverage Issues

A frequent issue that arises in §1031 transactions is how "leverage" can be used without triggering gain recognition.

Taxable boot in a like-kind exchange includes relief of liabilities on the relinquished property.[7] However, in calculating boot, a taxpayer may offset liabilities relieved in an exchange by liabilities assumed as part of the exchange.[8]

While this netting rule does not allow a taxpayer to offset cash received with liabilities assumed in the exchange, the courts have found that if a taxpayer is contractually obligated to use cash received in a like-kind exchange to satisfy the taxpayer's debt on the relinquished property, the payment of the cash should be treated the same as the relief of liabilities in calculating the boot on the exchange. Accordingly, the receipt of such cash could be offset by liabilities assumed by the taxpayer.[9]

In addition, a taxpayer can also offset boot received in the form of the relief of liabilities by the amount of any cash paid for the replacement property.[10] Thus, if a taxpayer either finances or pays cash for the replacement property in an amount at least equal to the liabilities relieved on the relinquished property (whether by the assumption of the liabilities by the buyer or by the contractual obligation of the taxpayer to use cash received in the exchange to pay off the liabilities), the taxpayer will have no boot in the exchange upon the relief of the liabilities.

Other leverage issues that arise in a like-kind exchange include whether a taxpayer can encumber replacement property immediately after the exchange or borrow against relinquished property immediately before the exchange. These practices allow taxpayers to effectively withdraw any equity in the replacement or relinquished property tax-free.

Borrowing against replacement property immediately after it is acquired should not defeat an otherwise good §1031 exchange as long as the debt is not incurred until after the exchange.[11] On the other hand, debt placed on relinquished property immediately before a §1031 exchange is a more risky transaction.

The Service has indicated that it may take the position that encumbering property "close in time" before a §1031 exchange could result in boot to the taxpayer.[12] However, logically, a taxpayer should be able to incur debt on relinquished property immediately before a §1031 transaction as long as the replacement property is encumbered by an equal or greater liability. This is so because, while the taxpayer is able to withdraw equity in the relinquished property, he is doing so by increasing the amount of his debt which is not a taxable event.[13]

Section 1031 … provides a valuable mechanism … to defer the payment of tax on appreciation in real estate and other investments.

Forms of Ownership

Many issues arise when a property targeted for transfer or exchange in a §1031 transaction is held in a tenancy-in-common or partnership arrangement.

Partnership interests cannot be exchanged tax-free under §1031.[14] And until recently, the Service's position on real estate versus partnership interest classification for §1031 purposes was unclear. Revenue Procedure 2002-22[15] sets forth guidelines that have become a safe harbor for structuring tenancy-in-common interests that can be acquired as replacement property under §1031.

Several of the Revenue Procedure's requirements are more essential than others for a tenancy-in- common arrangement to qualify under §1031. These essential requirements include that each co-owner must hold title to the property (either directly or through a disregarded entity) as a tenant-in-common and not through a recognizable entity under local law.

The permissible use of disregarded entities is important in satisfying requirements often imposed by co-owners that a judgment-proof entity hold the tenancy-in-common interest. Also significant under Rev. Proc. 2002-22 is the requirement that tenants-in-common not hold themselves out as engaged in a joint venture or a partnership (i.e., they should not file partnership tax returns, conduct business under a common name or execute an agreement identifying any or all of the co-owners as partners, shareholders or members of a business entity).

Further, under the Revenue Procedure, it is important that all owners retain approval rights over the most important issues affecting the property, such as the hiring of managers, the sale of the property or any leases of, or the creation or modification of blanket liens against, the property. For all other issues, the owners may agree to be bound by the vote of those holding more than 50 percent of the interests in the property.

This requirement may be met by including "implied consent" provisions in a tenancy-in-common agreement under which each co-owner is provided notice of certain events and given a specified period of time to object.[16] If none of the owners objects within the specified time frame, the matter is deemed to be approved.

Other requirements of the Revenue Procedure include that each co-owner must have the right to transfer, partition and encumber his interest in the property without the approval of the other owners, unless such restrictions are required by a lender. The Revenue Procedure further sets forth significant distributions and sharing restrictions under which, if the property is sold, any debt secured by it must be satisfied and the remaining proceeds distributed to the co-owners.

Also, each co-owner must share in revenues generated by, and all costs associated with, the property in proportion to the owner's interest in it, and no co-owner can advance funds to another co-owner to cover property expenses 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 the advance is for a period no longer than 31 days.

Partnership Property

A common source of friction involving sale property that is held through a partnership arrangement is how some of the partners can cash out while others receive replacement property in a valid

§1031 exchange.

If a partnership sells property and deposits only half of the proceeds with a qualified intermediary, the partnership would recognize the remainder of the proceeds as gain. If the gain was allocated equally to all of the partners, those who wish to reinvest would realize gain but receive none of the cash.

The most frequent method used to deal with such a scenario is the distribution by a partnership of undivided tenancy-in-common interests in the property to all of its partners immediately before the sale in liquidation of the partnership. Alternatively, the partnership could distribute these interests only to the partners who wish to cash out on the sale while the other partners remain in the partnership.

However, in the former case, it is not clear whether the relationship among the partners might still be deemed to be a partnership by the Service with the liquidation of the partnership. In addition, this calls into question whether the partners satisfy the requirement under §1031 that property be held for use in a trade or business or for reinvestment if the partners receive their undivided interests in the property immediately before the sale.

No authorities address these issues on point, and Rev. Proc. 2002-22 provides that the Service generally will not issue a ruling if the co-owners held interests in the property through a partnership immediately prior to the formation of the co-ownership arrangement. Despite these risks, many taxpayers have used this type of arrangement.[17]

The longer property is held in a tenancy-in-common arrangement prior to a §1031 transaction, the more likely it is that the IRS will accept a taxpayer's §1031 position with respect to the property. A holding period of one to two years after property was held by a partnership is an acceptable length of time in order to minimize any risk that an exchange will fail §1031 treatment.

An alternative approach used by partnerships to resolve discrepancies among partners with respect to §1031 treatment is to have the buyer of the relinquished property convey to the partnership cash and an installment note to purchase replacement property. The installment note would provide for 98 to 99 percent of the payments thereon to be made shortly after the closing and the remainder after the beginning of the succeeding tax year, allowing for installment note tax treatment under §453(b)(1) of the Code. The notes would be distributed to the cash-out partners in liquidation of their partnership interests.

No gain or loss should be recognized by the partnership on the receipt of the installment note, and the distribution of the note to the cash-out partners should not result in gain recognition until payments are made under the note. The partnership, which now would comprise only the partners wishing to do a §1031 exchange, would purchase replacement property. Since the partnership held the relinquished property and acquired the replacement property, the transaction should qualify for §1031 treatment.

Reverse Exchanges

Exchanges in which a taxpayer acquires replacement property before disposing of the relinquished property (a "reverse" exchange) have become more and more common since the Service issued Revenue Procedure 2000-37,[18] providing a safe harbor for qualifying a reverse exchange.

In a safe harbor agreement, an "Exchange Accommodation Titleholder" (the "EAT") or a single member LLC owned by the EAT acquires title to the replacement property and holds it for up to 180 days until a buyer is found for the relinquished property.

Within 45 days from the EAT obtaining legal title to the replacement property, the taxpayer must identify relinquished properties in a written notice to the EAT under the same rules concerning the identification of replacement properties in a forward exchange discussed above. The EAT then transfers the replacement property to the taxpayer for the relinquished property in a §1031 like-kind exchange (the "Swap Last Exchange").

The Revenue Procedure also allows for the exchange to be structured so that the taxpayer currently acquires the replacement property in a §1031 exchange and the EAT holds the relinquished property up to 180 days until a buyer is found (the "Swap First Exchange").

While Rev. Proc 2000-37 has made the federal income tax consequences of a reverse exchange clear as long as its requirements are satisfied, the state and local tax consequences of a reverse exchange still remain uncertain.

For instance, it is typical that many agreements used by EATs provide that the EAT will be treated as the taxpayer's agent for state and local tax purposes. This provision is expected to prevent the imposition of state and local transfer taxes twice when an EAT acquires replacement property from the seller (in a Swap Last Exchange) or when the EAT acquires the relinquished property from the taxpayer (in a Swap First Exchange). However, the effectiveness of this provision has not been sanctioned by any state or local authority.

Conclusion

Section 1031 of the Code provides a valuable mechanism for taxpayers to defer the payment of tax on appreciation in real estate and other investments. The arrangements by which a taxpayer can conduct a qualifying §1031 exchange have become more flexible with guidance issued by the IRS in recent years.

However, given that the United States is currently experiencing the lowest capital gains tax rates in recent history and the cost of acquiring replacement properties has escalated to a point where the "economics" of the replacement properties may be questionable, taxpayers should still carefully consider the economic prudence of such a deferral.

1. See Code §§1031(b), 1245(b)(4) and 1250(d)(4).
2. See Code §1031(c).
3. See Code §1031(d).
4. See Code §1031(a)(3).
5. See Reg. §1.1031(k)-1(c)(4)(i).
6. See Reg. §1.1031(k)-1(g).
7. See Reg. §1.1031(b)-1(c).
8. Id.
9. See *Commissioner v. North Shore Bus Co., Inc.*, 143 F.2d 114 (2nd Cir. 1944); *Barker v. Commissioner*, 74 T.C. 555 (1980).
10. See Reg. §1.1031(d)-2, Ex. 2.
11. See Lipton, "The 'State of the Art' in Like-Kind Exchanges — Revisited," 646 PLI/TAX 713 (February 2005).
12. See Priv. Ltr Rul. 8434015.
13. See Lipton, supra note 11.
14. See Code §1031(a)(2)(D).
15. 2002-14 IRB 733.
16. See Priv. Ltr Rul. 200327003.
17. See Lipton, supra note 11.
18. 2000-2 CB 308.

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