2016 REAL ESTATE TAX UPDATE
AND SECTION 1031 LIKE-KIND EXCHANGE REVIEW

REAL PROPERTY SECTION
NORTH CAROLINA BAR ASSOCIATION

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Introduction

This manuscript contains a survey of selected tax issues of interest to many real estate practitioners.

You will note that this manuscript is subdivided into two (2) Chapters.

Chapter One reviews current federal tax cases and IRS announcements affecting real estate entrepreneurs.

Chapter Two provides an overview of the rules applicable to Section 1031 exchanges.

CHAPTER ONE

RECENT FEDERAL TAX LAW DEVELOPMENTS

PART ONE
IRAs

I. IRA Funds Used To Purchase Land Are Deemed To Be An Early Withdrawal Where IRA Custodial Agreement Does Not Permit IRA Purchases of Real Estate.

In Dabney, TC Memo 2014-108 (June 5, 2014), Mr. Dabney wanted to use his self-directed Charles Schwab IRA funds to purchase undervalued real estate. However, Charles Schwab would not allow Mr. Dabney to purchase property directly through his IRA.

Accordingly, Mr. Dabney directed Charles Schwab to wire funds from his IRA account to the seller of real estate in Utah, and directed the title company to deed the property to the name of "Mr. Dabney Charles Schwab Company Custodial IRA Account." Mr. Dabney planned on selling the Utah property and then returning the sales proceeds to his IRA before the 60 day rollover period expired.

In 2009, when Charles Schwab wired the IRA funds to the seller of the Utah real estate, Charles Schwab showed this as a taxable distribution to Mr. Dabney. The title company deeded the Utah real estate directly into Mr. Dabney's name rather than into the name of "Mr. Dabney Charles Schwab Company Custodial IRA Account". Later, Mr. Dabney obtained a "scrivener's affidavit" from the title company in which the title company acknowledged responsibility for making an error in how the deed was transferred to Mr. Dabney, rather than into the name of his Charles Schwab IRA account.

In addition, when Mr. Dabney ultimately sold the Utah property in 2011, the funds were sent directly to Mr. Dabney's IRA. Mr. Dabney characterized the transfer as an IRA rollover contribution -- and that's how Charles Schwab recorded the deposit when it received the proceeds from the property sale in 2011.

Originally, when Charles Schwab sent its check to the seller of the Utah property, Charles Schwab issued a Form 1099 (Distributions from Pensions) showing that Mr. Dabney had taken a permanent withdrawal from his IRA. The IRS asserted that the 2009 distribution was taxable to Mr. Dabney and that the transfer of the sales proceeds in 2011 from the sale of the Utah property to Mr. Dabney's IRA at Charles Schwab was not a rollover contribution. Mr. Dabney argued that in 2009 he had taken title to the Utah property as agent for his self-directed IRA.

The IRS argued, and the Tax Court agreed, that although IRAs are not prohibited, under tax law, from owning real estate, the terms of any IRA Custodial Agreement (such as the Charles Schwab account agreement in this case) may serve to limit the type of rollover investments an IRA owner can make. Here, the Charles Schwab IRA Custodial Agreement prohibited investments in real estate.

Therefore, even though Mr. Dabney attempted to have the real estate retitled in the name of the custodial account, this did not accomplish a tax-free rollover of the IRA distribution into purchase funds used to purchase the Utah property. Here, the IRA did not purchase the Utah property and the IRA withdrawal was not a "trustee-to-trustee" rollover transfer.

Instead, in this case, the Court advised that Mr. Dabney should have undertaken a trustee-to-trustee rollover whereby Charles Schwab wired the purchase funds to another IRA Custodial trustee that would have permitted real estate investments and then allowed the new IRA trustee to purchase the real estate investment.

Ultimately, although Mr. Dabney was not subject to the accuracy related penalty, he had to pay tax on the failed rollover, plus a 10% early withdrawal penalty.

II. Self-Directed IRA Loses Asset Protective Status. In the case of Kellerman, 115 AFTR 2d 2015-1944 (May 26, 2015), aff'd 116 AFTR 2d 2015-5247 (September 14, 2015), the U.S. Bankruptcy Court held that the assets of a self-directed IRA became subject to the claims of creditors of the IRA owner who engaged in a "prohibited transaction" under Section 4975. Therefore, the IRA was not a protected exempt asset in the bankruptcy proceeding, and thus the assets of the IRA could be used to satisfy judgment creditors of the IRA owner.

PART TWO
ORDINARY INCOME OR CAPITAL GAIN ON THE SALE OF REAL PROPERTY?

I. Background and Overview.

A. Summary of Tax Differences. When a taxpayer sells real estate, often the IRS and the taxpayers are at odds as to whether the sale should be treated as the sale of investment property or as the sale of ordinary income "inventory" property. The tax differences can be significant for both the taxpayer and the IRS.

If the transaction is treated as a sale of "investment" real property, then any gain on the sale will be taxed at the **capital gain tax rates**. And the gain recognized by the investor will not be subject to self-employment taxes.

In addition to the capital gain tax and self-employment tax benefits available to the real estate investor, such investors also can benefit from:

(i) Section 1031 nontaxable exchanges;

(ii) Section 1033(g) (relating to condemnation of real property held for productive use in a trade or business or for investment); and

(iii) Section 453 installment sale reporting.

These are tax benefits that are **not** available to ***dealers*** of real property.

On the other hand, investors in rental real estate must be cognizant of (i) the passive activity loss limitations of Section 469 and (ii) the capital loss limitations applicable to investment property (since, if the sale generates a loss, then the taxpayer's loss will be limited by the capital loss limitation rules - that is, the capital loss can only offset other capital gains income and another $3,000 of ordinary income for the year).

If the sale is treated as a sale of **inventory** by a **developer**, then any gain will be treated as **ordinary income**, and thus will be subject to the ordinary income tax rates as well as subject to **self-employment tax**. On the other hand, if the sale of the deemed **inventory** generates a tax loss, then the tax loss will be **fully deductable** against other ordinary income as well as capital gains.

In this day and age, as compared with past years, we are much more inclined to argue that our clients are holding properties as inventory as opposed to for investment purposes. Since property values have diminished substantially over the last four years or so, many of our clients will seek to take the position that their loss property was held as inventory as opposed to property for investment purposes.

B. Past Case Law.

The issue of whether the sale of real property should be treated as the sale of investment property versus inventory property has generated much litigation in the past. Throughout various court cases analyzing these issues, most courts cite the "investor versus dealer tests" analyzed under Biedenharn Realty Company v. United States, 526 F.2d 409 (5th Cir. 1976); Suburban Realty Co. v. US, 615 F.2d 171 (5th Cir. 1980). Under these cases, the courts have focused on the question of whether the property is held primarily for sale to customers in the ordinary course of the taxpayer's business versus whether the taxpayers held the property purely for investment purposes.

Because gain or loss from the disposition of real property is capital if it was held as an investment and ordinary if it was held "***primarily***" for sale to customers, the identification of a particular parcel of real property as investment property or as property held primarily for sale to customers is critical.

According to the court in Malat v. Riddell (383 U.S. 569 (1966)), the term “primarily” means of “first importance” or “principally,” so that the issue turns on the taxpayer’s intent with respect to holding of the property, which is obviously a factual issue.

Accordingly, a taxpayer’s position, that an investment in real estate is merely being disposed of in the most economically profitable manner is a sustainable argument, despite the taxpayer’s engagement in activities traditionally conducted by a real estate dealer, provided that the taxpayer otherwise manages his property holdings in a manner substantially similar to that of an investor. Further, the taxpayer must be careful not to reinvest in substantially similar property shortly after the liquidation of the investment if he seeks to avoid ordinary income characterization.

Unfortunately, no definitive trend has arisen that identifies which factors will guarantee investor treatment. As the court in Biedenharn Realty Co., Inc. v. U.S. (526 F.2d 409 (1976)) noted, resolving this question is often a "vexing and ofttimes elusive" task. Obviously, however, the greater the degree of development and sales activities undertaken by the taxpayer, the more likely the taxpayer will be unsuccessful in sustaining its argument that the property is investor rather than dealer property.

Cases that have addressed the issue have emphasized various factors in different contexts, in a manner that makes it difficult to construct a pattern from which outcomes in other situations can be predicted with any degree of confidence. For example, the court in Kirschenmann v. Comr. (24 T.C.M. 1759 (1965) held that frequent sales of lots undertaken by the taxpayer because the property was no longer suited for its intended purpose did not make the property investment property, while the court in Austin v. U.S. (116 F. Supp. 283 (1953) reached the opposite conclusion on similar facts. Similarly, capital gain treatment was allowed to the taxpayer in Brenneman v. Comr. (11 T.C.M. 628 (1952)), who sold his lots after an ordinance was enacted that barred the taxpayer's original plans, while the taxpayer in Shearer v. Smyth (116 F. Supp. 230 (1953)) was required to pay tax at ordinary rates under similar circumstances.

C. Factors Reviewed By The Courts. The Court in Ada Belle Winthrop, (CA-5) 24 AFTR 2d 69-5760, rev'g (DC) 20 AFTR2d 5477, (October 22, 1969) established a set of criteria which have been cited frequently by the courts addressing these dealer vs. investor arguments. In the order of frequency cited in other cases, these seven factors, known as the "seven pillars of capital gain," are as follows:

1. Nature and purpose of the acquisition and duration of ownership.
2. Extent and nature of the efforts of the owner to sell the property.
3. Number, extent, continuity and substantiality of the sales.
4. Extent of subdividing, developing and advertising to increase sales.
5. Time and effort devoted to sales.
6. Character and degree of supervision over sales representatives.
7. Use of a business office to sell the property.

Other courts have applied a nine (9) factor test as follows:

1. The taxpayer's purpose in acquiring the property;
2. The purpose for which the property was subsequently held;
3. The taxpayer's everyday business and the relationship of the income from the property to the total income of the taxpayers.
4. The frequency, continuity, and substantiality of sales of property;
5. The extent of developing and improving the property to increase sales revenue;
6. The extent to which the taxpayer used advertising, promotion, or other activities to increase sales;
7. The use of a business office for sale of the property;

8. The character and degree of supervision or control the taxpayer exercised over any representative selling the property; and
9. The time and effort the taxpayer habitually devoted to sales.

Moreover, the Court of Appeals for the 5th Circuit has noted that "frequency of sales" is especially important to review because "the presence of frequent sales ordinarily runs contrary to the taxpayer's position" for investment. Suburban Realty Company.

II. Partnership's Sale of Real Property Generates Ordinary Income and Not Capital Gain.

In Fargo v. Commissioner, TC Memo 2015-96 (May 26, 2015), Mr. and Mrs. Fargo were the majority partners of a partnership (GDLP) that owned a leasehold interest in certain property located in La Jolla, California that it leased from La Jolla Country Club. GDLP entered into various agreements with related parties to develop the La Jolla Property.

In 1997, GDLP purchased the La Jolla Property from the La Jolla Country Club. Between 1997 and 2001, GDLP made some minimal efforts to develop the La Jolla property for residential use. At all times before 2001, the La Jolla property merely generated rental income to the GDLP partnership. Prior to 2001, the GDLP partnership never attempted to sell any of its property.

In 2001, an unrelated entity made an unsolicited offer to purchase the La Jolla real property from the GDLP partnership for $16 Million. Initially, the purchase price paid by the buyer was set at a fixed price of $16 Million. However, the parties later re-negotiated the deal for a purchase price of $14.5 Million plus a share of future home sales profits. And, under the sales contract, the GDLP partnership was obligated to continue efforts to develop the La Jolla Property. And, the GDLP partnership incurred significant expenses in further development of the La Jolla Property although these costs were reimbursed by the buyer.

The closing of the sale of the GDLP property occurred in 2002.

The court ruled that the entire gain recognized by the GDLP Partnership from the sale of the La Jolla Property was ordinary income and not capital gain, based upon the following factors:

1. The Purpose For Which The Property Was Initially Acquired. The parties agreed that the GDLP partnership initially acquired the La Jolla Property for development purposes. Here, however, the taxpayers argued that their purposes of acquiring the property was to benefit from its appreciation in value. Nevertheless, and unfortunately for the taxpayers, the taxpayers spent significant amounts of money and time trying to develop the La Jolla Property. This factor weighed in favor of the IRS.

2. The Extent Of Improvements On The Property. The Court noted that the GDLP partnership never substantially improved its property. And so, this factor weighed in favor of the taxpayer.

3. **Frequency, Number and Continuity of Sales.** The Court found that this factor was in favor of Mr. and Mrs. Fargo. Although Mr. Fargo was actively engaged in the real estate development business, the Court nevertheless found that his prior sales activities could not be attributed to the GDLP Partnership. Thus, this factor was in favor of the Fargos.

4. **The Extent and Nature of the Transactions Involved.** Here, there was only one sale of property associated with the transaction. However, because Mr. Fargo had agreed to work for the buyer in developing the property, and since the GDLP partnership would share in resulting profits from sold lots, this factor was in favor of the IRS.

5. **Efforts to Advertise and Solicit Sales of the Property.** Here, it was clear that the GDLP partnership never engaged in any efforts to sell or market the property.

6. **The Purpose For Which The Property Was Held Until The Time Of The Sale.** At the time the GDLP partnership sold the La Jolla property, it had incurred significant sums of money to attempt to develop the property. This factor weighed in favor of the IRS.

Summary. Based upon all of the foregoing facts, the Court held that the GDLP partnership at all times had held this property to generate sales to its customers and not for investment purposes.

III. Partnerships Held Real Estate as Inventory and Thus Were Not Eligible for Capital Gains Tax Treatment on the Sale of Properties.

In SI BOO, LLC TC Memo 2015-19 (February 4, 2015), the Tax Court held that three (3) related partnerships, that acquired Certificates of Purchase of Tax Liens from the local property tax collector, were engaged in the "trade or business" of selling real estate to customers.

In SI BOO, three partnerships actively sought out, and purchased, Certificates of Purchase of Tax Liens from the local county property tax collector. When the real property owners failed to pay delinquent county property taxes, the partnerships then acquired Tax Deeds for the real estate that were then sold in a relatively short period of time (i.e. within one or two years). One partnership had seventy (70) sales transactions over the two tax years at issue, the second partnership sold one hundred eleven (111) tracts and the third partnership sold seventy eight (78) properties.

All three (3) partnerships reported capital gains on the sales transactions. In addition, many sales were treated as installment sales -- where the purchase price was paid over multiple years.

Although the partnerships argued that their real estate sales were relatively modest, when compared to their overall purchases of Tax Lien Certificates, the Tax Court nevertheless held that the large number of real estate sales indicated that the taxpayers were in the "trade or business" of selling real estate to customers in the ordinary course of their business.

Therefore, the partnerships were not eligible for capital gains tax treatment, and could not use the installment method for the sales. The Tax Court further held that the profits from the sales were subject to self-employment taxes.

IV. Eleventh Circuit Reverses The Tax Court and Holds That Sale of "Lawsuit Rights" by Real Estate Developer Generate Capital Gain and Not Ordinary Income; *Long vs. Commissioner*, 114 AFTR 2d 2014-5446 (11th Circuit, November 20, 2014).

A. Background Facts.

Mr. Long was involved in several real estate development activities in Florida. In 2002, Mr. Long entered into a Contract (the "Contract") to purchase real estate located on Las Olas Boulevard (the "Property") from Las Olas Riverside Hotel ("LOR") in 2002.

When the Contract was executed, Mr. Long intended to build a condominium building on the Property and he then intended to sell off the condominium units to various purchasers.

The closing on the Property sale was scheduled to occur on December 31, 2004, but before the closing date, the president of LOR died, and his heirs decided that they did not wish to go through with the Contract sale.

In March 2004, Mr. Long sued LOR for "specific performance" and for monetary damages.

By the time Mr. Long filed the lawsuit however, Mr. Long had decided that he no longer wished to construct the condominium project on the Property; but instead he had decided to sell the Property, which was ready for construction, to another party, so that the buyer could complete construction of the condominium project.

The State Court ordered that LOR must perform its obligations under the Purchase Contract. During the appeal of that State Court case in September 2006, Mr. Louis Ferris purchased Mr. Long's "position in his lawsuit against LOR" for a purchase price of $5.75 Million.

In his 2006 tax return, Mr. Long filed a Schedule C reporting that he was a "real estate developer". However, Mr. Long reported the gain on the sale of the Property as a "capital gain" transaction. The IRS, however, took the position that the gain on the sale of the lawsuit rights should be taxed to Mr. Long at the ordinary income tax rates.

B. Tax Court Rules in Favor of the IRS.

In the Tax Court proceeding (TC Memo 2013-233, October 21, 2013), Mr. Long argued that he should be entitled to capital gains tax treatment on the sale of his lawsuit claim to Mr. Ferris on the basis that, at the time of filing his original lawsuit, he had decided to forego development of the condominium project, and instead had decided to sell the Property to one single purchaser.

The Tax Court then reviewed Section 1221 to determine whether Mr. Long's gain, from the sale of his lawsuit rights, should be taxed at the ordinary tax rates, versus the favorable capital gains tax rates.

The Tax Court noted that the purpose of Section 1221(a)(1) - which excludes inventory from the definition of a "capital asset" - is to "differentiate between gain arrived from the everyday operation of a business and gain derived from assets that have appreciated in value over a substantial period of time." *McManus vs. Commissioner*, 65 TC 197 (1975); and *Malat*, 383 U.S. 569 at 572 (9th Cir.). The Tax Court noted that, in determining whether or not property is "a capital asset" or "stock in trade" under Section 1221(a), courts often apply the nine factor test set forth in *Biedenharn*, *Winthrop* and *Suburban Realty Co.*

The Tax Court noted that the proper analysis focuses on Mr. Long's intention at the time the Property was disposed of in determining whether the Property was held for investment purposes or as inventory for sale in the ordinary course of the taxpayer's business. See, for example, *Rice v. Commissioner*, TC 2009 – 142; Raymond v. Commissioner, TC Memo 2001-96.

So, according to the Tax Court, the key analysis was whether, at the time that Mr. Long decided to sell the Property to another developer, was he intending to sell the Property to customers in the ordinary course of his business? Here, even though Mr. Long decided to sell the Property in one transaction, the Tax Court nevertheless held that the Property was "inventory," and not a capital asset, based upon the following factors:

1. The intent of Mr. Long at the time he acquired the Property. At the time he filed the original lawsuit, Mr. Long's intentions were to acquire the Property, design a condominium building, secure zoning approval, and then sell the undeveloped Property to another purchaser.

2. The Nature of the Taxpayer's Business. Mr. Long's fulltime business activity was developing real estate. And, at the time that he attempted to acquire the LOR Property, his fulltime activity was working on developing that Property for the condominium building.

3. Frequency, Continuity and Substantiality of Property Sales. Mr. Long had already received deposits from 20% of condominium purchasers, and therefore the Tax Court ruled that, although Mr. Long had changed his plans and decided to sell the Property ready for construction, this did not alter the Tax Court's view that Mr. Long held the Property primary for "sale to customers in the ordinary course of his business." Indeed, the sale of the Property would have generated a large profit which would have been the result of Mr. Long's effort to develop the Property -- and not the result of the mere passage of time.

4. Extent to which the Taxpayer Developed and Approved the Property. Here, Mr. Long hired architects, obtained zoning permit and printed promotion materials and negotiated contracts with Unit customers.

5. The Extent to which the Taxpayer Used Advertising. Through Mr. Long's own sales efforts, he had already received deposits on 20% of the Units.

6. Use of A Business Office. Mr. Long used a business office to sell the condominium units.

7. Character and Degree of Supervision or Control Exercised by the Taxpayer over any Representatives on the Property. The court said that, if Mr. Long had not sold his rights under the lawsuit to Mr. Ferris, then he would have been primarily responsible for selling the Property.

8. Time and Effort the Taxpayer Devotes to Sales of Property. Here, Mr. Long was a professional real estate developer, and his full time business was developing and selling condominium properties.

Based upon the foregoing, the Tax Court held that the gain from the sale of Mr. Long's rights under the Purchase Contract should be "ordinary income," as he would have earned ordinary income on the sale of the Property. The Tax Court also upheld assessment by the Section 6662(a) "accuracy-related" penalty.

C. Eleventh Circuit Court of Appeals Reverses The Tax Court.

Previously, the Tax Court agreed with the IRS that the sale of "lawsuit rights" generated ordinary income, and not capital gain, to Mr. Long. The Tax Court first addressed whether the "property" Mr. Long intended to sell (as defined in Section 1221(a)(1)) was (1) the land, (2) the land plus the building, or (3) the individual condominium units. The Tax Court had determined that the "property" -- for purposes of Section 1221(a)(1) -- was land ready for construction, but nevertheless held the profit from the sale was ordinary income to Mr. Long.

Ultimately the Tax Court ruled that, if Mr. Long had not sold his lawsuit rights, then he would have earned ordinary income through the sale of developed condominium units after the state court ordered specific performance of the Purchase Contract with LOR.

The 11th Circuit Court of Appeals took a much different approach than the Tax Court did.

The 11th Circuit Court of Appeals held that the Tax Court misapplied Code Section 1221(a)(1) by construing that the "property" at issue here was the land, rather than the "right to acquire the land." Indeed, Mr. Long did not sell the land itself, but instead he sold his rights in a lawsuit to acquire the land. Here, Mr. Long never owned the Property.

Also, Mr. Long did not sell his right to future income, but instead he simply sold his right to "attempt to finish developing" a large residential project that was far from complete. Citing previous case law, the Court noted that selling a right to "earn" future undetermined income, as opposed to selling a right to "earned" income, is a critical feature of a capital asset. *United States vs. Dresser Industries, Inc.*, 324 F2d 56, 59 (5th Cir. 1963).

Therefore, since Mr. Long was selling his right to a lawsuit, it was irrelevant that the income from developing the project ultimately would have generated ordinary income to Mr. Long. So, the "property" at issue was the lawsuit itself and not the "undeveloped property." Here, the "property" -- subject to analysis under Section 1221(a)(1) -- was Mr. Long's exclusive right to purchase the Property by virtue of the Florida state court judgment.

And, at the time that Mr. Long entered into the Purchase Contract, he did not have any intent to "assign his contractual rights in the ordinary course of his business" nor was there any evidence that, in the ordinary course of his business that he obtained the Florida court judgment for the purpose of assigning to a third party his business position as plaintiff in a lawsuit.

V. One Single Lump Sum Sale of Property Generated Ordinary Income And Not Capital Gain: *Allen v. US*, 113 AFTR 2d 2014-873 (DC CA May 28, 2014).

In Allen, the District Court for California was called upon to determine whether Mr. Allen was entitled to treat his sale of 2.63 acres of undeveloped real estate as capital gain or as ordinary income.

Mr. Allen was a civil engineer who primarily worked for developers. In 1987, Mr. Allen purchased 2.63 acres of undeveloped real estate in Palo Alto, California. Previously, under oath and in an IRS deposition, Mr. Allen testified that he purchased the property for the purpose of developing the property himself for sale. Later, Mr. Allen contended that he purchased the property as "investment" property."

In his testimony, Mr. Allen admitted that, between 1987 and 1995, he undertook significant efforts to develop the property on his own. However, from 1995 through 1999, Mr. Allen attempted to find investors and partners to take over the project because he needed to sell the property. During the entire time that Mr. Allen owned the 2.63 acres, his own engineering firm developed approximately 10 set of plans for development of the property as he continued to seek to find a partner or investor to develop the project.

In 1999, Mr. Allen sold the property to Clarum Corporation for installment payments over time. In 2004, Mr. Allen received a final installment payment and reported this payment as capital gain.

However, Mr. Allen admitted that, when he received payments from Clarum Corporation in prior years before 2004, he reported these payments as "other income" on his tax return. Later, Mr. Allen changed his testimony and asserted that, in prior years, he treated the gain as capital gain and not as ordinary income.

The California District Court held that Mr. Allen's gain in 2004 was ordinary income and not capital gain. The court found that, during the entire time that Mr. Allen owned the property and beginning when he purchased the property, he always intended to develop the property and that he undertook substantial efforts to develop the property during the entire time he owned it.

Also, there was no doubt that Mr. Allen was very active in his efforts to develop the property – for example, his company created around 10 different sets of plans for development.

Mr. Allen, however, argued that his intent with respect to the property **changed over time** when it became clear to him that he did not have the experience, expertise or ability to develop the property himself. The court ruled, however. that while a purchaser may be able to prove that his intent with respect to holding certain property has changed over time, in this case, Mr. Allen was not able to show when, how or why his intent in holding the property changed over time.

Perhaps Mr. Allen's best argument, that he was an investor and not a dealer, was the fact that Mr. Allen ultimately sold the property all in one transaction rather than in separate multiple transactions. The court looked to the factor of "extent and substantiality" of the transactions, as Mr. Allen argued that he had only purchased one piece of investment property and that he had eventually only sold that property once, and therefore that single transaction could not amount to a sale "in the ordinary course" of Mr. Allen's trade or business.

However, the court felt that this fact was not determinative. According to the court, in determining whether someone is an investor versus a developer, there is no "one bite" rule. Thus, a taxpayer -- who only engages in one venture -- can still be held to be in a trade or business as to that one business venture or as to that one property sale.

Finally, Mr. Allen also argued that he was a civil engineer and not a real property dealer. However, the court said that a taxpayer can be engaged in more than one trade or businesses.

Thus, Mr. Allen was found to be a developer by virtue of his extensive efforts and attempts to develop the property in question, even though those development efforts ultimately were unsuccessful.

VI. Husband and Wife Were Deemed Dealers Rather Than Investors In Real Property, So Gain On Sale of Land To A Developer Was Taxable As Ordinary Income And Not Capital Gain.

The case of *Boree v. Commissioner*, TC Memo 2014-85 (May 12, 2014), involved the issue of whether Mr. and Mrs. Boree could treat gains on their sale of real property to a developer as capital gains, rather than as ordinary income.

A. Background of Facts. In 2002, Mr. Boree and Daniel Dukes formed Glen Forrest, LLC and purchased almost 2,000 acres of land in Florida for a purchase price of approximately $3.2 Million. The purchase price was funded with almost $1.9 Million in loans from a local bank in addition to $250,000 of funds that they had borrowed from their parents.

Immediately after the closing of the purchase of the 2,000 acres, the LLC sold approximately 280 acres of the Glen Forrest property to eight (8) purchasers.

In 2003, Glen Forrest sold approximately 15 lots of the Glen Forrest property and began building an unpaved road on the property. Glen Forrest, LLC then began planning a residential development community on the Glen Forrest property which would consist of over 100 lots.

Glen Forrest, LLC then applied for, and received exemptions for, subdivision requirements that allowed Glen Forrest to sell lots without completing the interior roads or submitting plats to the local governing board.

In 2003, Glen Forrest executed a Declaration of Covenants and created a homeowners association to enforce the Declaration and to maintain the common area. The Declaration referred to "Glen Forrest" as the developer.

During 2004, Glen Forrest sold approximately six (6) lots of the Glen Forrest property. During 2005, Glen Forrest sold approximately 17 lots.

In March 2005, Mr. and Mrs. Boree purchased Mr. Duke's interest in the LLC and then became the sole owners of Glen Forrest. In May 2005, Glen Forrest submitted a proposal that the Glen Forrest property be rezoned as a planned unit development (PUD). In September 2006, Glen Forrest withdrew its PUD application and instead requested non-PUD zoning changes.

In February 2007, Glen Forrest sold over 1,000 acres of the Glen Forrest property to Adrian Development for $9.6 Million.

On their 2005, 2006 and 2007 tax returns, Mr. and Mrs. Boree reported on their Schedule C tax returns that their principal business was being "Land Investors." However, for 2005 and 2006, Mr. and Mrs. Boree reported income from Glen Forrest sales of lots in 2005 and 2006 as ordinary income and they deducted (rather than capitalized) expenses relating to the Glen Forrest property.

However, on their 2007 tax return, Mr. and Mrs. Boree indicated that Mr. Boree's occupation was that of a "Real Estate Professional" and for 2007 they reported a long-term capital gain of almost $8.6 Million relating to the Adrian transaction. The IRS challenged the Boree's characterization of the 2007 sale of their remaining Glen Forrest property as long term capital gain and contended that the Borees should recognize ordinary income on the transaction.

B. <u>Tax Court Decision</u>. The Tax Court noted that, prior to the large sale in 2007, Mr. and Mrs. Boree subdivided the Glen Forrest property, built a road and spent significant time and money in zoning activities in pursuing their continuing development activities. In addition, between 2002 and 2006, Mr. and Mrs. Boree sold approximately 60 lots which consisted of almost 600 acres of the Glen Forrest property. The sales of these lots, up until 2007, reflected their intent to develop the Glenn Forrest property and sell sub-divided lots to customers.

In addition, after Mr. and Mrs. Boree purchased the interest of Mr. Duke, the Borees continued to engage in significant sales and development activities with respect to the Glen Forrest property. For example, Mr. and Mrs. Boree reported their sales of lots in 2005 as ordinary income and they deducted (rather than capitalized) expenses related to their real estate activities.

Also, they did not "segregate" the property sold to Adrian Development from the rest of the Glen Forrest property.

Accordingly, the sale of the remaining acreage in 2007 generated ordinary income and not capital gains to the Borees. The court also upheld the assessment of the substantial understatement penalty under §6662(a).

PART THREE
DEDUCTIONS

I. Sister Was Not Entitled to a Mortgage Interest Deductions for Payments On Brother's Mortgage.

In Puentes v. Commissioner, TC Memo 2013-277 (December 9, 2013), Ms. Puentes lived with her brother in a home that was titled solely in the brother's name. After losing his job, the brother could no longer make his mortgage payments. Although Ms. Puentes was not liable on the mortgage debt, she started making the brother's mortgage payments and then claimed a mortgage interest deduction for the mortgage interest paid to the lender. The IRS disallowed Ms. Puentes' mortgage interest deductions.

The brother was the sole legal and beneficial owner of the residence and Ms. Puentes could not prove that she was the legal or "beneficial" owner of the residence. Indeed, there was no agreement between Ms. Puentes and her brother that gave her any ownership interest in, or beneficial rights to, the house or from the proceeds from the sale of the home. Therefore, all beneficial interest and burdens of the home rested solely in the brother. Also, Ms. Puentes was not liable in any way for the mortgage debt as this was a debt solely of Ms. Puentes' brother.

Here, the Court noted that a taxpayer may become the "equitable owner" of property where the facts demonstrate that he or she assumes the benefits and burdens of ownership of the property. Baird v. Commissioner, 68 TC 115 (1977) and Blanche v. Commissioner, TC Memo 2001-63. A court would consider certain factors to determine whether a taxpayer has assumed the benefits and burdens of ownership of the property, including the following:

(1) whether the taxpayer had the right to possess the property and to enjoy its use, rents and profits thereof;

(2) whether the taxpayer had the duty to main the property;

(3) whether the taxpayer was responsible for insuring the property;

(4) whether the taxpayer bore the risk of loss of the property;

(5) whether the taxpayer was obligated to pay taxes, assessments and charges against the property;

(6) whether the taxpayer had the right to improve the property, and

(7) whether the taxpayer had the right to obtain legal title to the property at any time by paying the balance of the purchase price.

Here, Ms. Puentes was not able to offer any evidence that she had any agreement with her brother entitling her to an ownership interest in the home or any beneficial rights to its rents or the proceeds from its sale, or the right to purchase the property later on. Moreover, there was no evidence that Ms. Puentes was legally obligated to bear any significant burdens of ownership.

Therefore, Ms. Puentes was not able to establish that she ever had gained beneficial or equitable ownership interest in the home. Therefore, since she was not in any way liable for the debt and since she was not a beneficial or equitable owner of the home, she was not entitled to any mortgage interest deduction for her mortgage loan repayments.

II. A Tenant's Large Lease Termination Payment For a Lease Buy-Out Results In An Ordinary Income Deduction Even Though The Tenant Purchased The Subject Property From The Landlord.

In *ABC Beverage Corporation v. US*, 113 AFTR 2d 2114-934 (June 13, 2014), the Court of Appeals for the Sixth Circuit allowed a tenant, that exercised an option to purchase property that it was leasing from the landlord, to deduct a portion of the amount tendered in the transaction as a deductible lease termination payment. The IRS had previously argued that the full amount paid by the tenant to purchase the property and to terminate the lease must be capitalized as part of the overall purchase price for the leased property.

Code §167(c)(2) provides that where real property is acquired subject to a lease, the purchaser is not allowed to allocate any basis to the leasehold interest.

A. Background Facts. In 1987, ABC Beverage Corporation signed a lease that, initially, was to last for 300 months but the lease provided for five (5) successive five year renewal options.

Under the terms of the lease, the tenant had the option to purchase the leased property for an amount equal to the "fair market value" of the leased property. The lease defined the "fair market value" of the property as the fair market value of the leased premises which would include the value of the lease that encumbered the property.

In 1996, ABC notified the landlord that it was exercising its right to purchase the property. However, the landlord and ABC could not agree on the fair market value of the leased property under the terms of the lease. In 1999, the parties entered into an agreement in which they agreed that the fair market value of the property would be at least $9 Million, but no more than $11.5 Million.

Ultimately, the parties entered into an agreement in 1999 and ultimately ABC purchased the property from the landlord for $11 Million.

On its 1997 tax return, the tenant (ABC Beverage Corporation) claimed a lease termination deduction expense of $6.25 Million and capitalized the leased property for $2.75 Million. Based upon appraisals obtained by ABC, ABC determined that the fair market value of the property was $2.75 Million, but that based upon terms of the lease, ABC would have to pay at least $9 Million to acquire the Property subject to the lease. Thus, ABC concluded that the cost of buying-out the lease was $6.25 Million.

B. Decision of Sixth Circuit Court. The IRS had argued that Code §167(c)(2) prohibits any allocation of the purchase price of the property to a leasehold interest. Accordingly, the IRS contended that ABC could not claim any of the cost of terminating the leasehold as a business expense.

However, the 6th Circuit Court noted that, previously, the Court of Appeals held that §167(c)(2) did not apply where the property was subject to a lease, already with the tenant as the lessee before the tenant acquired the property. Allerton, 166 F.2d 805 (6th Cir. 1948). Therefore, according to the Court, when ABC acquired the property it was already leasing, the leasehold interest would merge with the "larger estate" so that the property would no longer be subject to the lease. This meant that ABC could currently deduct the entire $6.25 Million lease termination payment.

III. No "Business" Bad Debt Deduction Allowed For a Real Estate Dealer.

In Langert v. Commissioner, TC Memo 2014-210 (October 8, 2014), Mr. Langert was a real estate developer and property manager. Mr. Langert bought, sold and rented real estate property and also engaged in the business of providing real estate management services for certain rental properties.

At various times during his career, Mr. Langert made six (6) different loans on different occasions. However, Mr. Langert did not advertise himself to be a money lender and Mr. Langert did not keep a separate office or maintain separate books or records relating to any of the loans that he had made.

In 2003, Mr. Langert borrowed almost $200,000 from Merrill Lynch and he secured that loan with a lien on rental property that he owned in Maryland. In that same year, Mr. Langert loaned $157,000 of the Merrill Lynch loan proceeds to Mr. Gordon and Mr. Gordon issued an unsecured promissory note to Mr. Langert for the balance of the loaned funds. Mr. Gordon then used the proceeds of the unsecured loan from Mr. Langert to purchase certain real property also located in Maryland.

After Mr. Gordon defaulted in his loan obligations to Mr. Langert, Mr. Langert unsuccessfully attempted to recover the loan balance owed by Mr. Gordon. Mr. Langert then attempted to claim a Section 166 business bad debt deduction for the worthless loan owed by Mr. Gordon.

The Tax Court held that Mr. Langert was not able to establish that he was in the "trade or business" of making loans or that the loan furthered his real property business endeavors. Mr. Langert contended that his purpose in making the loan was to obtain interest income, but the court held that this was insufficient to establish that the loan was made in connection with Mr. Langert's trade or business. The Court noted that, in past cases, the courts have held that, in order for a taxpayer to be entitled to a bad debt deduction under Section 166(a) in connection with the taxpayer's trade or business of lending money, the debt must have been sustained in the course of the taxpayer's activity of making loans that was "so expensive and continuous as to elevate that activity to the status of a separate business." Imel v. Commissioner, 61 TC 318, 323 (1973).

The Court held that making approximately six (6) loans to individuals over a thirty (30) year period did not elevate that activity to the status of a separate business enterprise. Therefore, the Court ruled that Mr. Langert was not able to establish that the transfer of the funds to Mr. Gordon constituted (1) a debt created or acquired in connection with Mr. Langert's trade or business or (2) a debt the loss from the worthlessness of which was incurred in Mr. Langert's trade or business.

PART FOUR
PASSIVE LOSS CASES AND "AT RISK" RULES

I. Background of Passive Activity Loss's Rules. Section 469 denies passive activity losses to an individual, an estate or trust, a C corporation or a personal service corporation. Under Section 469(a), a "passive activity" is defined as any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. The term "passive activity" however, generally includes any rental activity, regardless of material participation. Section 469(d)(2). The Code defines “rental property” as “any activity where payments where payments are principally for the use of tangible property”.

Congress enacted Section 469 to prevent taxpayers from applying losses from rental properties and other passive business activities to offset and shelter non-passive income such as wages, dividends or profits from non-passive activities. See S. Rep. No. 99-313, at 716-18 (1986).

II. Special Rules for Real Estate Professionals.

A. Background of Real Estate Professional Rules. A "rental activity" is generally treated as a passive activity regardless of whether the taxpayer materially participates in that rental activity. Section 469(c)(2). However, pursuant to Section 469(c)(7)(B), the rental activities of a "real estate professional" are not per se "passive activities" under Section

469(c)(2), but instead are treated as a trade or business subject to the "material participation" requirements of Section 469(c)(1). Reg. Section 1.469-9(e)(1).

Under Section 469(c)(7)(B), a taxpayer qualifies as a "real estate professional," and thus is not engaged in a passive activity under Section 469(c)(2), if:

(1) more than half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real estate property trades or businesses in which the taxpayer "materially participates;" **and**

(2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

However, even if the requirements of Section 469(c)(7)(B) are met, and even if the taxpayer qualifies as a real estate professional, a taxpayer's rental activity will be treated as a "passive activity" under Section 469(c)(1), **unless** the real estate professional taxpayer materially participates in the activity.

Moreover, in determining whether a taxpayer materially participates in a trade or business, the participation requirements must be met with respect to **each** **interest** in rental real estate **unless** the taxpayer makes an election to treat **all** interests in rental real estate as a single real estate activity (the "aggregation/grouping election"). Section 469(c)(7)(A). Thus, a qualifying taxpayer may elect to aggregate or group **all** of his activities and treat them as one activity for purposes of applying the material participation tests. Sec. 469(c)(7)(A). However, once the election is made, it applies for that tax year and for all future tax years. Reg. 1.469-9(g).

B. How to Make The Grouping Election for a Real Estate Professional. Reg. Section 1.469-9(g)(3) provides that a qualifying taxpayer (a real estate professional) makes the election to treat all interest in rental real estate as a single rental activity – for purposes of determining if they have materially participated in the activity - by filing a statement with the taxpayer's **original** income tax return for the taxable year (the "grouping election"). IRC Reg. §1.469-9(g)(3) describes the information that must be contained in the grouping election statement. Pursuant to Reg. Sec. 1.469-9(g)(3), the statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to Section 469(c)(7)(A).

C. Rev. Proc. 2011-34 (May 26, 2011). Until recently, once the due date for filing the original return had expired, the taxpayer would have to apply for a Private Letter Ruling request under Reg. Sec. 301.9100-1(c) (and pay a use fee) in order to request an extension of time to make a late aggregation election for that tax year. Now, under the new Revenue Procedure, real estate professionals may make a late grouping election by filing an Election Statement with an amended return for the most recent tax year. The Election Statement must

identify the tax year for which the taxpayer seeks to make the aggregation election effective, and the Election Statement must state at the top that is "Filed Pursuant to Rev. Proc. 2011-34".

In this Election Statement, the taxpayer must make the following representations under penalties of perjury:

1. The taxpayer failed to make the election solely because the taxpayer failed to timely meet the requirements of Section 1.469-9(g);

2. The taxpayer filed consistently with having made an election under Reg. 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends for the requested aggregation to be effective and no tax returns contain positions inconsistent with the requested aggregation have been filed with respect to any of those tax years;

3. The taxpayer **timely filed each tax return** that would have been affected by the election if it had been timely made; and

4. The taxpayer has "reasonable cause" for its failure to meet the requirements of Reg. 1.469-9(g).

Note: So, as indicated above, not only can the aggregation election be made with respect to the most recent tax year, but the aggregation election will be effective as of the first tax year in which the taxpayer seeks to have the election apply.

III. Taxpayer Could Not Provide Adequate Documentation To Substantiate Status as a Real Estate Professional; *Merino v. Commissioner, TC Memo 2013-167 (July 16, 2013).*

Mr. Merino was the President and sole shareholder of One Stop Home Loans, Inc., an S Corporation. In addition, during 2007 Mr. Merino operated a business known as Mona Vie, Inc., which involved the sale and distribution of a berry drink.

Mr. Merino also operated a real estate rental activity in 2007 involving seven (7) rental properties. One property was located out of state and Mr. Merino used a management company to manage that property. With respect to the other properties, Mr. Merino paid an assistant an hourly rate to handle property management services.

The rental activity generated a loss for 2007 and Mr. Merino took the position that the losses were deductible under Section 469(c)(7) on the basis that Mr. Merino qualified as a real estate professional. The Tax Court determined that Mr. Merino could not meet either (1) the "one-half of services" test or (2) the "750 hour" test.

The problem here was that Mr. Merino did not present any evidence at trial as to how many hours he spent working at One Stop and at Mona Vie. Since Mr. Merino could not meet the "one-half-of-services" test of Section 469(c)(7), the rental activity was deemed passive.

The Court went further on to say that Mr. Merino also failed to substantiate the "750 hour requirement." The Court noted that a taxpayer may substantiate that he meets the "750 hour test" by "any reasonable means," and "any reasonable means" does not require that the taxpayer have contemporaneous records compiled on a daily basis. Reg. Section 1.469-5T(f)(4). Instead, the taxpayer may use any reasonable method, such as identifying specific services performed over a period of time by using appointment books, calendars or narrative summaries and then estimating the approximate number of hours spent on these activities. Reg. Section 1.469-5T(f)(4). However, the IRS regulations do not allow the taxpayer to use a post event "ball park guesstimate." Moss v. Commissioner, 135 TC 365 (2010).

Here, the Court found that Mr. Merino's time summary relied upon his estimates and memory as to how much time he spent on certain tasks, and that his summary was less of an approximation and more of a "ball park guesstimate." The Court also upheld assessment of negligence penalties.

IV. IRS States that Mortgage Brokers Are Not "Real Estate Professionals" For Purposes of Section 469.

In Internal Legal Memorandum 201504010, the IRS issued its opinion that a mortgage broker is not engaged in a real property "trade or business" for purposes of qualifying as a "real estate professional" under Section 469(c)(7). However, the ILM indicates that a real estate broker may be able to qualify as a real estate professional.

V. Tax Free Gain on Sale of Primary Residence Will Not Offset Suspended Passive Activity Losses Generated From Rental Of Former Primary Residence.

In Chief Council Advice 201428008 (July 11, 2014), the taxpayer purchased a primary principal residence for $700,000 and used it as a principal residence for two years before converting the residence to rental property. Then, the taxpayer rented the residence and generated passive activity losses for the next two years. The taxpayer did not deduct these losses as they were passive activity losses and thus were carried forward as suspended passive losses for purposes of Section 469.

Within three (3) years of converting the property to rental property, the taxpayer sold the residence for $800,000, which generated a $100,000 gain that was excludable under Section 121 of the Internal Revenue Code, since the residence was used as a primary personal residence for two (2) out of the last five (5) years.

The question here was what happens to the taxpayer's suspended Section 469 Passive Activity Losses? Would the non-taxable gain upon disposition of the residence absorb the losses? Or, would the taxpayer be able to exclude the $100,000 gain under Section 121 and then use the suspended passive activity losses for possible future tax purposes?

The IRS noted that, when a passive activity is disposed of, any gain from the sale of the passive activity is treated as passive activity gross income for the taxable year of disposition under Reg. §1.469-2T(c)(2)(i)(A), such that any gain from the disposition of the passive activity would be treated as passive activity gross income which would then be offset by any suspended passive activity losses. However, if the activity was not a passive activity of the taxpayer at the time of disposition, then the gain is treated as not from a passive activity.

Here, since Mr. Taxpayer owned the residence for two of the last five years as his principal residence, the residence was not a "passive activity," but instead was a principal residence. So, any gain on the sale of the residence would be treated as a §121 item, and not as gain from the disposition of a passive activity. This meant that the taxpayer would be allowed to (1) exclude the $100,000 gain under §121 without reduction for any passive activity losses from prior years and (2) continue to carry the suspended passive activity losses forward to future years when he might have passive income that could be reduced and offset by the suspended passive activity losses.

VI. <u>The "At Risk" Rules and Guarantees of LLC Debt.</u>

Internal Revenue Legal Memorandum 201308028 discusses when an LLC member will be "at risk" with respect to guaranteed LLC debt. This ILM reminds us that, if a member of an LLC personally guarantees debt of the LLC, but has rights of subrogation or contribution or indemnity from other third parties, then the LLC member will not be "at risk" under Section 465 unless and until the rights of subrogation, contribution or indemnity are waived or until the co-guarantors and indemnitors become insolvent.

<u>PART FIVE</u>
NOMINEE, TRANSFEREE AND SUCCESSOR TAX LIABILITY CASES

I. <u>Transferee, Successor and Nominee Liability Rules.</u>

A. <u>Background of Section 6901 Transferee Liability Rules</u>. Under the Code Section 6901 "transferee liability" rules, there are three (3) types of transferee liability that can arise when someone acquires assets from a taxpayer that owes taxes to the IRS:

1. <u>Contractual transferee liability</u> – which arises where the transferee assumes a tax paying obligation of the transferor;

2. <u>Statutory transferee liability</u> – which is usually imposed by federal or state law (often known as fraudulent conveyance statutes); or

3. <u>Equitable transferee liability (also called the "trust fund" theory)</u> - which is assessed for example when a corporation (owing taxes) distributes its assets to its shareholders who are then jointly and severally liable for the unpaid taxes of the transferor corporation to the extent of assets received from the corporation.

B. <u>"Alter Ego" and "Successor Liability" Theories for Pursuing IRS Collection Actions Against a Transferee.</u> IRS Internal Legal Memorandum 200847001 (released November 21, 2008) provides a thorough explanation of theories the IRS may advance in seeking to hold a transferee of assets liable for taxes owed by the transferor-taxpayer. In this ILM, the IRS National Office thoroughly examines the "alter ego" and "successor liability" theories for pursuing collection activities against a transferee who receives assets from a taxpayer-transferor.

1. <u>Alter Ego Theory</u>. As discussed in the ILM, the "alter ego theory" usually involves the "piercing of the corporate veil" to hold a shareholder liable for the debts of a corporation, or the "reverse piercing" to hold the corporation liable for the debts of a shareholder. The ILM cites a number of past court cases which have imposed "alter ego" liability against a transferee corporation - even without a formal stock ownership relationship between the transferee corporation and the taxpayer. In these cases, courts looked to control, and not the mere "paper ownership," to determine whether to apply the alter ego theory.

2. <u>Successor Liability Theory</u>. In addition, the ILM also discusses the "successor liability" theory for imposing liability on the transferee. Under the state law of most states, "successor liability" imposes liability upon a transferee in the following circumstances:

1. When a successor expressly assumes the liabilities of the transferor;
2. When the transaction amounts to a defacto merger;
3. When the successor is a "mere continuation" of the seller corporation; and
4. When the transaction is entered into fraudulently to escape liability.

The "defacto merger" and the "mere continuation" exceptions both generally look to whether the successor corporation shares common officers, directors and shareholders with the transferor corporation. Other factors to be considered include the continuity of business operations, management, assets, personnel and physical location. Also, courts will consider whether there was sufficient consideration paid by the buyer to the seller in exchange for the transferred assets.

3. <u>No New Assessment Required Against Transferee</u>. Finally, the Chief Counsel advised that the IRS is not required to make an additional assessment against the transferee where there was already a preexisting assessment against the transferor. Since the successor corporation steps into the shoes of the transferor corporation, a new assessment against the transferee corporation is not required.

C. <u>Nominee Liability: Taxpayer Could Not Escape Tax Lien by Transferring Property to a "Nominee;" U.S. vs. Jones, 109 AFTR 2d 2012-1072 (February 17, 2012)</u>.

In <u>U.S. vs. Jones</u>, 109 AFTR 2d 2012-1072 (February 17, 2012), Mr. and Mrs. Jones owed millions of dollars of tax debts. The IRS ultimately filed tax liens against the Jones' property. At various times, Mr. and Mrs. Jones transferred various properties to certain trusts and to other nominees.

The IRS then filed federal "nominee" tax liens and the IRS then sought to foreclose on the properties. In allowing the foreclosure sale to proceed against the nominees, the Court noted that, notwithstanding the Jones' transfer of the properties:

(i) the Joneses still acted and operated as the owners of those properties;

(ii) many of the transfers happened after the tax liens were already filed; and

(iii) worse, many of the transfers were made for no adequate consideration and the transfers were made to family members or to entities controlled by family members.

This case is notable in that it articulates a six (6) factor test often applied by the courts to review whether the IRS can assert **nominee liability**:

(1) No consideration paid by the nominee;
(2) Debtor continues to exercise control over transferred property;
(3) Close relationship between transferor and nominee;
(4) Failure to record conveyance;
(5) Retention of possession by debtor; and
(6) Continued enjoyment of property by debtor.

Note: Also, the transferee-nominees could not qualify as Code Section 6323(a) "protected" purchasers. Section 6323(a) protects a "purchaser" who pays full and adequate consideration for a taxpayer's property prior to the IRS filing a Notice of Federal Tax Lien. For this purpose, the term "adequate and full consideration" means consideration that has a "reasonable relationship to the true value of the interest in the property acquired." Section 301.6323(h)-1(f)(3); U.S. vs. McCombs 30 F3d 310 (2nd Cir. 1994).

II. IRS Asserts Nominee Tax Lien on Assets of a Single Member LLC; *Berkshire Bank v. Town of Ludlow, 111 AFTR 2d 2013-498, 708 F3d 249 (January 11, 2013).*

Mr. Livermore owned 15 acres of undeveloped land that he wanted to develop as a residential subdivision.

Ultimately, Mr. Livermore formed a single-member LLC, called WAL Development, LLC ("WAL"), and transferred the property to the new LLC. Later, Mr. Livermore racked up huge tax deficiencies, due in part from income generated from WAL.

In 2009, the IRS assessed a "nominee tax lien" against the assets of WAL, and in 2010, the City of Ludlow recorded a judgment lien against the assets of WAL. The Court concluded that the nominee tax lien was valid and thus had priority over the judgment lien in favor of the City of Ludlow.

The Court looked at the following factors, often applied by the Courts, to determine whether the owner of the property (WAL) could be treated as the "nominee" of the taxpayer as follows:

(1) The lack of consideration paid by the titleholder;

(2) A close relationship between the taxpayer and the title holder;

(3) The control exercised over the property by the taxpayer while title is held by another;

(4) The use and enjoyment by the taxpayer of the property titled to another;

(5) Lack of interference in taxpayer's use of property by titleholder;

(6) The use of property or funds titled to another to pay the taxpayer's personal expenses;

(7) Whether the taxpayer exercises dominion and control over the property, or treats it as if it belongs to him; and

(8) Whether title was placed in the record owner's name as a result of or in anticipation of the taxpayer's liability.

Here, the Court noted that Mr. Livermore had properly recorded a deed transferring the property to WAL, that WAL had always been maintained as a valid Massachusetts LLC, that Mr. Livermore had kept records of WAL's transactions and that he kept these records separate from his personal records. Also, Mr. Livermore's attorney kept a "corporate book" for the LLC and Mr. Livermore had maintained a separate bank account for WAL.

The problem here was that many of the other factors favored the IRS. For example, Mr. Livermore kept the WAL bank account titled in Mr. Livermore's name, and he frequently transferred funds from this account to his personal bank account. The Court stated:

> We do not wish to suggest, as Ludlow fears, that a single-member, single-purpose LLC can never escape nominee status for purposes of a federal tax lien. But under the circumstances presented here, there was simply too much intermingling of funds and too close of a relationship between Livermore and WAL for us to conclude that WAL was anything other than "a legal fiction."

> **Note:** This case reminds us of how critically important it is that we meticulously maintain the separate existence and observe corporate formalities.

III. Successor Liability Must be Determined by State Law, Rather Than By General Federal Common Law

In *TFT Galviston Portfolio, Ltd. vs. Commissioner*, 144 TC No.7 (February 26, 2015), the taxpayer was a Texas limited partnership that acquired a number of apartment projects from other Texas entities. Several of the selling entities had IRS tax liabilities for unpaid income and employment tax withholdings.

The IRS sought to hold TFT responsible for the income and employment tax liabilities of the prior owner entities on the basis that TFT was the "successor in interest" of the those other entities. The IRS contended that the Tax Court should apply broad federal common law in determining whether TFT was a "successor in interest" to the prior entities.

TFT, however, argued that, since the transactions all were based in Texas, the Tax Court should apply Texas state law to determine whether TFT, under Texas law, could be held liable for debts and obligations of the prior entities under Texas law.

The Tax Court ruled that specific Texas state law, rather than federal common law, should be applied to determine whether TFT was a "successor in interest" to the prior selling entities. Next, in applying Texas state law, the court noted that the Texas Business Organization Act specifically states that a person "acquiring property … may not be held responsible or liable for a liability obligation of the transferring domestic entity that is not expressly assumed by that person."

The Tax Court then noted that other states -- having state laws similar to Texas -- will occasionally apply three (3) narrow exceptions to the "non-liability" rule.

First, there is an exception where the transaction is tantamount to a "de facto merger." But, Texas law did not recognize the concept of a "de facto" merger doctrine.

The second exception is when the successor entity is a "mere continuation" of the seller. But again, this also was a doctrine that Texas courts had refused to apply.

And finally, the third exception is where the transaction was entered into fraudulently (i.e., under a fraudulent conveyance theory). Here, however there was no evidence of a fraudulent conveyance.

So, the court refused to hold TFT liable for the outstanding tax debts of its predecessors.

North Carolina Successor Liability Rule. The NC Court of Appeals case Joyce Farms vs. Van Vooren Holdings, Inc., 756 S.E. 2d 355 (March 4, 2014) sets forth the general rule in NC relating to "no successor liability" and the four (4) exceptions thereto.

Under the general "no successor liability rule," a corporation which purchases all or substantially all of the assets of another corporation is not liable" for the transferor's liabilities. Budd Tire, 90 N.C. App. At 687, 370 S.E. 2d at 269. However, the Court held that the general "no successor liability" rule does **not** apply where:

(1) there is an express or implied agreement by the purchasing corporation to assume the debt or liability;
(2) the transfer amounts to a de facto merger of the two corporations;
(3) the transfer of assets was done for the purpose of defrauding the corporation's creditors; or
(4) the purchasing corporation is a "mere continuation" of the selling corporation in that the purchasing corporation has some of the same shareholders, directors, and officers.

IV. Again, State Law, and Not Federal Law, Determines Transferee Liability.

Also, in William Stewart v. Commissioner, 114 TC No. 12 (April 1, 2015) the Tax Court rejected the IRS' attempted use of the federal "substance over form" doctrine for purposes of applying Section 6901 transferee liability theory, and instead ruled that, to determine whether a transferee is liable under Section 6901, the Court must review the state law of the state in which the transfer occurred.

Nevertheless, the Tax Court held that under Nebraska law, since the transfer occurred in Nebraska, the transferee faced liability exposure under Section 6901 under Nebraska state law, and not under the federal common law concept of "substance over form."

V. An Estate Disclaimer by An Heir Is Not Effective to Avoid Tax Liens.

In the Estate of Deinlein v. U.S., 114 AFTR 2d 2014-5390 (July 23, 2014), the Kentucky District Court held that the tax liens of an heir attached to proceeds of a condominium devised to the heirs.

Mrs. Deinlein died in 2001, survived by her sons. At the time of her death, Mrs. Deinlein owned a condominium located in Kentucky.

One son, Chris, had outstanding federal tax liabilities and tax liens at the time of Mrs. Deinlein's death. Chris disclaimed his interest in the condominium.

The Court held that the disclaimer did not prevent Chris' interest in the condo from being attached by the federal tax lien. See Drye v. U.S., 528 US 49 (1999).

PART SIX
IRS LIENS AND FORECLOSURES

I. When Can The IRS Foreclose on Jointly-Owned Property To Satisfy Liens of One Property Owner?

A. Background. IRC Section 7403 allows the IRS to apply to the court for permission for a foreclosure sale in order to sell jointly-owned property partially owned by an IRS tax debtor. Once the IRS secures a federal tax lien against the taxpayer's real property, the IRS generally has ten (10) years to foreclose upon its federal tax lien. If the taxpayer attempts to sell his real property during the ten (10) year lien period, the IRS will collect some or all of what it is owed at the time the sale occurs. However, the IRS does not have to wait for a sale to enforce its tax lien. Indeed, under § 7403, the IRS can file a civil action in district court to enforce the tax lien.

Once the IRS has commenced its civil action in District Court under § 7403, it can then proceed to foreclose on the subject property. However, once the case is filed, the District Court is not ***required*** to allow the IRS to proceed with the foreclosure sale. Instead, under § 7403(c), the district court is required to "finally determine the merits of all claims" and after doing so the court "may decree" a sale. In other words, the District Court has **some discretion** in deciding whether or not to allow a foreclosure sale to proceed.

Also, the IRS is limited to the extent to which it can exercise its foreclosure powers to foreclose on property that is **jointly owned by a taxpayer and another third party**. In the case of United States vs. Rogers, 461 US 677 (1983), the US Supreme Court placed limitations on the IRS' ability to foreclose on **jointly owned property** subject to a tax lien.

In the Rogers case, the U.S. Supreme Court discussed four (4) factors that govern whether the U.S. may use its limited discretion to foreclose on property that is also jointly owned by an "innocent third party." The Rogers Supreme Court articulated four (4) factors that the Tax Court should consider when deciding whether to foreclose on property that is jointly owned with an innocent third party:

1. The extent to which the IRS would be prejudiced if it were relegated to make a forced sale of the partial interest actually liable for the delinquent taxes;

2. Whether the innocent third party joint owner had a legally recognized expectation that the separate property would not be subject to forced sale by the taxpayer or by a creditor to satisfy the legal obligations owed by the taxpayer;

3. The potential prejudice to the third party, both in terms of personal dislocation costs and under compensation; and

4. The relative character and value of the non-liable and liable interests held in the property.

II. <u>The 6th Circuit Court Of Appeals Allows The IRS To Foreclose Upon "Tenants By The Entirety" Real Property To Satisfy The Tax Liabilities Of Only One Spouse</u>. <u>U.S. vs. Winsper</u>.

In <u>Winsper</u>, Mr. and Mrs. Winsper owned joint real property located in Kentucky. The IRS held a federal tax lien against Mr. Winsper for unpaid federal income taxes of over $900,000. The IRS sought to foreclose upon Mr. Winsper's one-half interest in the property pursuant to Section 7403 and sought permission of the District Court to force a foreclosure sale.

A. <u>The Tax Court Trial; Winsper, 106 AFTR 2d 2010-6945 (November 3, 2010)</u>. The Tax Court refused to allow the IRS to foreclose on Mr. Winsper's interest in the property to satisfy his tax liens. Here is how the District Court applied § 7403 in light of the four (4) factor test set out in the U.S. Supreme Court case in <u>Rogers</u>:

<u>First Factor: The extent to which the IRS would be prejudiced if it were relegated to make a forced sale of the partial interest actually liable for the delinquent taxes</u>.

The <u>*Winsper*</u> Court noted that there was significant disagreement as to the value of the property. The higher the value of the property, then there would be a greater prejudice against the IRS if it was not allowed to foreclose. The IRS argued the property was worth $300,000 (but offered no appraisal) while the taxpayer presented an appraisal of the property at $136,000. Both the taxpayer and the IRS agreed that a foreclosure sale would only bring about 80% of the appraised value.

The Court determined that the actual value of the property was closer to $200K and that, if it had allowed a foreclosure sale, the foreclosure sale would only bring in around $160,000 upon a foreclosure sale. And, after prior first mortgages were satisfied, only around $145,000 would be left. After other foreclosure expenses, this would leave only around $71,500 of funds to pay Mr. Winsper's tax liabilities (since he only owed half (½) of the property) which only represented about 8% of his total tax liability at the time.

The Court also noted that, if the foreclosure sale was further delayed, then this would work against the interest of the IRS. On the other hand, Mr. Winsper had owed taxes for almost ten (10) years before the potential foreclosure sale and the foreclosure sale would only render a small portion of funds that could be used to pay against Mr. Winsper's tax liability. Thus, the Tax Court viewed that, by forestalling the foreclosure sale until some later time, this would not prejudice the interest of the IRS.

<u>Second Factor: Did the Other Joint Owner Have An Expectation That The Jointly Owned Property Would Not Be Foreclosed Upon</u>?

Next, the Court reviewed Kentucky law to determine whether a spouse would have a reasonable expectation that jointly-owned property would not be foreclosed upon to pay the tax debts of a spouse. In reviewing Kentucky law, the Court determined that the Kentucky courts had previously held that a spouse would not have a reasonable expectation that her property interest could be foreclosed upon to pay the debts of a spouse.

> **Note:** This is very similar to North Carolina law which provides that tenancy-by-the-entirety real estate, owned between a husband and wife, cannot be used to pay off debts of one spouse. On the other hand, under North Carolina law, "tenants in common" ownership interests are subject to debts of either co-owner. Likewise, under North Carolina law, if co-owners own real estate, even with rights of survivorship, North Carolina law does not protect non-spouses from creditor foreclosure.

Third Factor: The Likely Prejudice to the Third Party Co-Owner.

The Court next determined that, if the IRS foreclosed on the real property, then Mrs. Winsper would only receive around $71,500 from her sale of the one-half interest in the property. This amount was so small that Mrs. Winsper would not be able to relocate her principal residence to another property or even to other reasonable housing. So, this factor favored against foreclosure of the property.

Fourth Factor: The Relative Character and Value of the Non-Liable and Liable Interests in the Property.

The Court determined that Mr. and Mrs. Winsper appeared to own a 50/50 interest in the home and the Court concluded that this was a substantial ownership interest by Mrs. Winsper. So, if the IRS foreclosed on this property, then the IRS's foreclosure would detrimentally affect Mrs. Winsper since she owned a full 50% ownership interest in the home.

Based upon all these facts, the Court refused to allow the IRS to foreclose upon the home owned by Mr. and Mrs. Winsper.

B. Sixth Circuit Court of Appeals Overturns the Winsper Decision and Allows Foreclosure Sale of "Tenants by the Entirety" Marital Home and Found That The District Court Had Misapplied The Rodgers Equity Test; U.S. v. Winsper, 109 AFTR 2d 2012-2069 (May 10, 2012).

On appeal, the 6th Circuit Court of Appeals overturned the District Court on the basis that the District Court had misapplied the Rodgers' equity test. According to the 6th Circuit Court of Appeals, the District Court based its earlier decision on a mischaracterization and misapplication of the four (4) factor "balancing test" in Rogers as requiring that the Government must prove factors ***supporting*** the Government's discretion to force a foreclosure sale; instead, however, the proper test was to determine when the Court should **not** have discretion to force a foreclosure sale.

According to the Court of Appeals, under the Barr decision, the Rogers case "did not mandate application of the four factor balancing test before a District Court could order a sale under Section 7403." Barr, 617 F3d at 375-76.

The Court of Appeals also noted that, in looking at the underlying factors of Winsper, the District Court had wrongly focused on the fact that only a small percentage of Mr. Winsper's tax debt would be satisfied in determining that the Government would suffer little prejudice if limited to selling only Mr. Winsper's partial interest in the marital home. And indeed, such an analysis would favor a taxpayer who has significant tax debts.

Also, the Court of Appeals noted that, while the District Court properly found that Mrs. Winsper had a legally recognized expectation of no "forced sale" under state law, the Court record failed to show that Mrs. Winsper would actually suffer prejudice from a forced sale.

Ultimately, the Court of Appeals ordered the District Count to remand the case for further discussion to re-evaluate whether to exercise its limited discretion to **not order** a foreclosure sale based upon all the relevant factors.

C. Winsper; On Remand, The District Court Of Kentucky Allows the IRS To Foreclose On "Tenants-By-The-Entirety" Real Property To Satisfy Husband's Tax Debts; Winsper, 114 AFTR 2d 2014-5218 (DC KY), 07/15/2014.

Previously, the 6^{th} Circuit Court of Appeals held that the District Court originally abused its discretion in not allowing the IRS to foreclose on the Winsper's marital residence to satisfy Mr. Winsper's tax debts. The 6^{th} Circuit then remanded the case back to the District Court in light of the United States Supreme Court's decision in Rogers, 461 U.S. 677 (1983). The 6^{th} Circuit had ruled that the District Court had misapplied three (3) of the four (4) Rogers factors and noted that "the Rogers factors did not address the scope of the government's discretion to foreclose but, rather, the District Court's discretion not to foreclose."

Accordingly, on remand, the District Court re-examined the Rogers four-factor balancing test to determine whether or not it should exercise its discretion to deny the IRS's motion to foreclose on the Winsper's spousal property to satisfy Mr. Winsper's tax lien.

The District Court looked to the first factor of Rogers and that is "the extent to which the government's financial interests would be prejudiced if it were relegated to a forced sale of the partial interest actually liable for the delinquent taxes." If the sale of Mr. Winsper's partial interest in the spousal property could satisfy Mr. Winsper's debt owed to the government, then a forced sale of the entire property would be unnecessary.

Previously, the 6^{th} Circuit held that, "given the minimal value of Mr. Winsper's partial interest, the government has a greater interest in a forced sale of the entire property." Here, the value of the residence was roughly $200,000, and it was agreed that if there was a forced sale of the entire property, then the government would receive only about $71,500.

Also, even though the unpaid tax assessment would still be very significant after applying the foreclosure proceeds, the focus should not be on the percentage of Mr. Winsper's debt that would be satisfied, but rather the focus should be on the dollar amount that would be collected. The 6^{th} Circuit had previously held that the percentage of debt to be satisfied is not important in terms of the potential prejudice to the government's financial interests.

Next, the District Court noted that Mrs. Winsper indeed had a legally recognizable expectation that her interest in the tenants-by-the-entirety property would not be subject to a forced sale by Mr. Winsper's creditors (the second Rogers Factor).

However, Mrs. Winsper was not able to satisfy the third factor of Rogers, and that is the likely prejudice to the non-liable third party in terms of "personal dislocation costs" and in terms of "under compensation." Previously, the Kentucky District Court found that the $71,500 that Mrs. Winsper would receive from a forced sale of the entire residence would not allow her to find other reasonable housing. However, the 6th Circuit held that this conclusion was unsupported by any evidence submitted by Mrs. Winsper. Since Mrs. Winsper did not provide any new evidence on this issue, the District Court ruled that this factor weighed in favor of the government.

Next, the District Court looked at the fourth Rogers factor, which instructs that "a court should consider the relative character and value of the non-liable and liable interests held in the property." Rogers 461 U.S. at 711. If the non-liable third party has an interest in the property and "that interest is worth 99% of the value of the property, then there might well be virtually no reason to allow the sale to proceed." Id.

Previously, the District Court concluded that Mrs. Winsper's interest in the property was 50% or more based upon the fact that she was much younger than Mr. Winsper. But, the 6th Circuit held that "any claim that Mrs. Winsper might have an interest in the property greater than 50% based on the likelihood that she will outlive her husband is precluded by this Court's decision in Barr." Winsper 680 F.3d at 492; see Barr, 617 F.3d 370, 372 (2010). Here, under Kentucky law, tenants by the entirety have identical equal property rights and thus there will be an equal division of the rights even if the tenants-by-the-entirety was terminated. Thus, this fourth factor was neutral.

Accordingly, the District Court allowed the IRS to proceed with a forced sale of the tenants-by-the-entirety real property.

Conclusion: What does this court case tell us?

We have a lot of clients out there who hold "jointly-owned" interests in real estate with other partners/investors. With respect to real estate owned by a husband and wife as "tenants-by-the-entirety," the real estate arguably should be protected under North Carolina law from IRS liens filed against only one spouse (but see Barczyk and Winsper above). In those cases, we hope the IRS (or North Carolina Department of Revenue) will not attempt to foreclose upon the real estate, but instead will wait until the real estate is sold.

In other cases, we have clients who own investment real estate (beach real estate, mountain home vacation real estate, etc.) owned by investors as tenants in common. And in some cases, we even have spouses who own real property as "tenants in common" and not as "tenants-by-the-entirety." These property interests are not protected by North Carolina state law. Instead, any such tenants in common real property will be subject to creditors' claims owed by either of the tenants in common.

So, we should not be surprised when IRS liens arise against the interests of a one-half tenants in common owner. In those cases, we need to be prepared to fight off IRS attempts to foreclose on this real property under the foreclosure powers under § 7403.

In these cases, we need to be prepared to assert that, under the Rogers case, the IRS should not be permitted to foreclose upon these partial interests under the following arguments:

> 1. Real Estate Property Values Are At an "All-Time" Low. So, the IRS would be much better served if it would forestall foreclosure sales until a later year after property values have increased.
>
> 2. The innocent third party would be substantially prejudiced by a foreclosure against the tax liable partner, since
>
> > (a) a foreclosure sale rarely brings in the full value of the property; and
> >
> > (b) the ownership interests of the non-liable co-tenant usually are significant in terms of character and value.
>
> **Also see** U.S. v. Staton, 116 AFTR 2d 2015-5947 (August 31, 2015), where the U.S. District Court of Hawaii permitted the IRS to foreclose on tenants by the entirety real property to satisfy tax debts owed only by the husband.

III. Federal Tax Lien Was Extinguished Upon the Death of Joint Tenant of Survivorship Property.

In NPA Associates, LLC vs. Estate of Cunning, 114 AFTR 2d 2014-5364 (October 17, 2014), the District Court for the U.S. Virgin Islands held that the death of a joint tenant served to extinguish a tax lien on jointly-held property. In this case, Mr. Cunning and Ms. Wrenn were owners, as joint tenants with right of survivorship, of real property located in U.S. Virgin Islands. In 2010, the IRS recorded a tax lien against Mr. Cunning. Mr. Cunning died in November 2011.

After Mr. Cunning's death, the IRS attempted to enforce the tax lien against the jointly-held survivorship property.

The Tax Court ruled that, when Mr. Cunning died, Ms. Wrenn succeeded to Mr. Cunning's interest in the property by operation of law. Here, the District Court for the Virgin Islands ruled that, based upon the earlier U.S. Supreme Court decision in U.S. v. Rogers, 461 US 677 (1983), tax liens "cannot extend beyond the property interests held by the delinquent taxpayer." And, the federal tax lien statute itself creates no property rights, but merely attaches consequences to rights created under state law.

Moreover, the Internal Revenue Manual, Section 5.17.2.5.2.2(4) states that "in most states, if the individual, against whose property a federal tax lien attaches, dies before any of the other joint tenants, then the lien ceases to attach to the property…[s]tate law should always be consulted to determine whether there is an exception to this general rule."

The Court noted that the U.S. Virgin Islands law did not have any specific statute or case law that addressed what happens to liens if one joint tenant dies and property passes to a surviving joint tenant, but the Court concluded that the Supreme Court of the Virgin Islands would not depart from the general rule that any such liens would be extinguished upon the death of the first tenant to die.

Therefore, the Court ruled that the IRS tax lien, which attached only to Mr. Cummings' interest in the property, was extinguished upon his death.

CHAPTER TWO
2016 SECTION 1031 TAX FREE EXCHANGE UPDATE

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I. Introduction. Tax free exchanges, pursuant to Section 1031 of the Internal Revenue Code, continue to be an important part of real estate practice.

In light of the deferred exchange regulations which were issued in 1991, most exchanges now are structured through a "qualified intermediary." This has brought dramatic simplification and added certainty to these types of transactions. This Article will briefly review the rules for effecting an exchange using a "qualified intermediary" and will then address some of the special issues which arise from time to time.

Finally, even though tax free exchanges under Section 1031 have been around for some time, transactions often arise which are in the "gray area" of this statute. Therefore, this Article also reviews some of the rules and some of the issues which are open in this area.

II. Review of Section 1031 Rules.

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, as long as the relinquished property is exchanged only for property of "like-kind" that likewise will be held either for productive use in a trade or business or for investment. There are five requirements for a tax-free exchange.

(1) There must be an "exchange" of relinquished property for replacement property;

(2) Each "property" must not be excluded by statute from potential like-kind exchange treatment; for example, stock in a corporation and partnership interests and inventory held by a dealer are excluded from possible like-kind exchange treatment;

(3) The replacement property must be "of like-kind" to the relinquished property;

(4) Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment; and

(5) The acquirer of the replacement property must be the same as the seller of the relinquished property.

III. **Review of Qualified Intermediary Rules For "Deferred Exchanges."**

Most exchanges are "deferred" exchanges. That is, property (the "Relinquished Property") is sold by the seller, and the seller later acquires property ("Replacement Property") from someone else to constitute the exchange. The purpose of the "qualified intermediary" is to provide a "straw man" for the transaction and to hold the seller's money from the time the Relinquished Property is sold until the new Replacement Property is bought. Here are the mechanics:

1. Taxpayer enters into a Sales Contract for the sale of the Relinquished Property.

2. Taxpayer enters into a Qualified Intermediary Exchange Agreement (before the sale of the Relinquished Property) with a qualified intermediary. (We have found that it is easy and convenient to use one of the local title insurance companies or banks as a qualified intermediary for this purpose).

3. Taxpayer assigns the Sales Contract, for the sale of the Relinquished Property being sold, to the qualified intermediary under the terms of the Qualified Intermediary Exchange Agreement.

4. Taxpayer must notify the buyer in writing (before the sale of the Relinquished Property) of the assignment of the Sales Contract to the qualified intermediary, and the buyer must acknowledge, in writing, receipt of Notice of the Assignment of the Sales Contract.

5. At the closing of the sale of the Relinquished Property, the proceeds must be paid **directly** to the Qualified Intermediary. It is very important that the proceeds are not payable to the Taxpayer or a person who might be considered the Taxpayer's agent.

6. The Taxpayer/Seller must "identify" the property the Taxpayer/Seller wishes to acquire in exchange for the Seller's property (the "Replacement Property"). This identification must be done within 45 days of the date Taxpayer/Seller conveys his Relinquished Property.

The identification must be done in writing strictly in accordance with the IRS rules. The Taxpayer/Seller may identify up to **three (3) properties** from which the Taxpayer/Seller may later choose. The Taxpayer/Seller may also identify as many properties as Taxpayer/Seller wants to identify - so long **as the "total value" of all identified properties does not exceed 200% of the fair market value** of the Relinquished Property – but, who knows what "total value" means?

7. The Taxpayer/Seller enters into a Purchase Contract for the Replacement Property that the Taxpayer/Seller desires to acquire.

8. The Purchase Contract for the Replacement Property must then be "assigned" to the Qualified Intermediary.

9. The seller of the new Replacement Property must be notified in writing (and before the sale) of the assignment of the Purchase Contract to the Qualified Intermediary, and the seller of the Replacement Property must acknowledge, in writing, receipt of the Notice of Assignment of the Purchase Contract.

10. Taxpayer closes the purchase of the Replacement Property. This must be completed by the **earlier of** the following dates: (i) 180 days after the sale of Taxpayer's property, or (ii) the due date for filing the taxpayer's tax return for that year (normally April 15 of the following year **–** unless the taxpayer files an Extension Application to extend the filing due date).

11. Notification is issued to the Qualified Intermediary to instruct the Qualified Intermediary to release the proceeds to the Seller to purchase the Replacement Property.

12. Title to the Replacement Property must be conveyed to the exact same person or entity that owned (and sold) the Relinquished Property. For example, if only the Husband's name was on the deed to the Relinquished Property, then the Replacement Property must not be deeded into the names of Husband and Wife; instead, the Replacement Property must be deeded to the Husband only.

13. For the tax year the Taxpayer effects the like-kind exchange, the Taxpayer must file IRS Form 8824 together with Taxpayer's tax return.

It is very important that each of these steps be timely. For example, the entry into the Qualified Intermediary Exchange Agreement must occur before the sale of the Relinquished Property. Also, the Assignments and Notices must occur before the sale or purchase of Relinquished or Replacement Properties, as the case may be.

IV. Special Section 1031 Issues: Frequently Asked Questions (FAQs). Here are some frequently asked questions concerning the Section 1031 rules:

1. What if the purchase price of my replacement property is less than the sales price of my relinquished property? In an exchange, you must pay tax on the lesser of any cash received in the exchange or the amount of the gain on the sale. This means that, where the Taxpayer's purchase price on the Replacement Property is less than the sales price of the Relinquished Property, the Taxpayer must pay tax on the difference between the sales price of the Relinquished Property and the purchase price of the Replacement Property. Also, the amount of the gain **is not reduced** by any of the Taxpayer's tax basis in the Relinquished Property.

2. What happens to my tax basis in my Relinquished Property? The Taxpayer's income tax basis in the Relinquished Property is "rolled into" his tax basis in the new

Replacement Property. This means that any gain not recognized on the sale of the Relinquished Property is deferred until the Replacement Property ultimately is sold.

3. What if the Taxpayer's mortgage is paid as part of the sale of the Relinquished Property? Generally, when property subject to a mortgage is sold, the buyer insists that the mortgage be paid out of the sales proceeds at closing. Accordingly, a debt of the Taxpayer is paid. Does this mean the Taxpayer is in "constructive receipt" of cash?

> Example: Taxpayer owns Relinquished Property with a basis of $50,000 and a mortgage of $250,000. The Relinquished Property is sold in an exchange transaction for $400,000. At the closing, the mortgage is paid.

Clearly, the taxpayer will have to replace the Relinquished Property with Replacement Property costing at least $400,000 in order to avoid the recognition of any gain. Interestingly, the regulations specifically address the situation where exchanged Replacement Property is sold subject to a mortgage, in other words, where the mortgage is assumed by the buyer. In that case, the regulations make clear that, so long as the taxpayer acquires replacement property subject to a mortgage of a like amount, the boot paid offsets the boot received. Treas. Reg. § 1.1031(b)-1(c). Although this is helpful, it is also a fairly uncommon transaction because, as noted above, mortgages are almost always paid off. Logically, the payment of a mortgage should have the same result as the assumption of a mortgage. See Commissioner v. North Shore Bus Co., 143 F 2d 114 (Second Cir. 1974).

4. Is it possible to receive an installment note and still do a like-kind exchange? Sometimes, the buyer of the Relinquished Property gives the Taxpayer an installment note for part or all of the sales price for the Relinquished Property. The installment note has certain advantages in that taxation is deferred until the receipt of the note payments. However, in a Section 1031 transaction, the note represents boot, and, accordingly, the note itself (or the proceeds of the note) will cause gain to be recognized.

> Example: Taxpayer's property has a basis of $50,000. She has arranged to sell the property for $200,000. The Taxpayer is to receive $75,000 in cash and a note for $125,000. The Taxpayer exchanges the property (through a qualified intermediary) for $200,000 of Replacement Property. The Taxpayer has received $125,000 in boot and will have to recognize gain (on the installment method) accordingly.

An interesting planning opportunity arises under a quirky regulation dealing with the interplay of the installment sales rules and Section 1031. Under Temp. Treas. Reg. § 15A.453-1(b)(3)(i), the receipt of proceeds from a qualified escrow account or qualified intermediary in a failed exchange is treated as a payment on an installment obligation. This is the case, however, only if the taxpayer has a "bona fide intent" to exchange at the beginning of the transaction.

This is interesting, for example, where a transaction occurs in 2015 and that there is no acquisition of exchange property, and where the proceeds will be received from the qualified intermediary or from the escrow account in 2016. Accordingly, the proceeds should be taxable in 2016. This has the effect of deferring taxation on the payment and possibly shifting the payment into a year with a lower tax rate. It is not clear how encumbered properties fit into this system.

This is another reason why it is a good idea to structure sales as exchanges - even if the taxpayer is not sure whether she wishes to proceed with the exchange.

5. Can an exchange be combined with a foreclosure situation?

> Example: Taxpayer purchased improved real property for a $200,000 promissory note. Later, after many years of depreciation, the taxpayer's basis in the property is almost zero, and the taxpayer has elected to give the property back to the noteholder. It appears that the transfer of the property back to the noteholder can be structured as a Section 1031 exchange. However, in order to completely defer recognition of gain, the taxpayer would have to use a qualified intermediary in order to acquire Replacement Property worth at least $200,000.

6. Suppose the taxpayer must acquire Replacement Property now, but is not in a position to sell his Relinquished Property until later on?

> Example: Taxpayer has identified an apartment building that he wishes to acquire in a Section 1031 exchange. Taxpayer is also planning to sell an office building he has owned for some time. For business reasons, Taxpayer must close on the purchase of the apartment building within thirty days. However, he has not yet found a buyer for the office building. What are the options?

a. Leasing. Where the taxpayer must acquire the replacement property first (that is, before the taxpayer is prepared to sell the exchange relinquished property), one alternative is for the taxpayer to simply lease the replacement property from the seller. The seller will generally demand a lease payment equal to his "carrying costs" for the replacement property. Of course, the seller will also want to ensure that he has a deal. One way to effect this is to grant the seller a “put” right, which allows the seller to require the taxpayer to purchase the replacement property from the Seller.

Similarly, the taxpayer will want to secure an option to purchase the replacement property. This all leaves a lease of the replacement property with a fair market rent, but allowing the taxpayer/lessee with an option to purchase the replacement property and the lessor a "put right" to require that the taxpayer/lessee purchase the property.

The concern with this is that the IRS may take the position that such a lease is, for all intents and purposes, a conveyance of the property to the taxpayer. Therefore, the same property could not be later received in an exchange. One possible technique in this situation is to grant the lessee an option to purchase the replacement property at whatever the agreed upon value is. If the taxpayer/lessee does not exercise the option by a outside date, the rental is increased substantially. Hopefully, the increased rental protects the seller/lessor and also provides a motivation to the buyer/lessee to exercise the option and purchase the property.

b. **<u>Revenue Procedure 2000-37 Now Allows A “Safe” Harbor For Reverse Like-Kind Exchanges Through The Use Of The “Qualified Exchange Accommodation Arrangement” (QEAA).</u>** The QEAA arrangement is facilitated by a “exchange accommodation title holder” (EAT). The following steps illustrate how the QEAA arrangement with an EAT must be structured under the "reverse" exchange safe-harbor:

1. The EAT (such as a title company or other unrelated party) would create a single-member limited liability company. The seller of the replacement property would then transfer the replacement property to the LLC (or the taxpayer would transfer the relinquished property to the LLC).

2. At the time replacement property is transferred to the EAT, LLC, the taxpayer must intend to complete a Section 1031 exchange.

3. Once the EAT, LLC acquires ownership of the replacement property (or the relinquished property), that ownership must continue uninterrupted until the replacement property is ultimately transferred back to the taxpayer and, during this time, the EAT must 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 ownership of the property on their federal returns consistent with this arrangement.

4. Within in five business days after the relinquished or replacement property is transferred to the EAT, the taxpayer and the EAT must enter into a written QEAA which provides as follows:

(a) The EAT is the "beneficial" owner of the property for the benefit of the taxpayer to facilitate a Section 1031 exchange under Revenue Procedure 2000-37;

(b) The parties agree to report the acquisition, holding and disposition of the property as provided in Revenue Procedure 2000-37; and

(c) The taxpayer and the EAT must treat the EAT as the beneficial owner of the property for all federal income tax purposes.

5. No later than 45 days after the transfer of the Replacement Property to the EAT, the taxpayer must "identify" his Relinquished Property as property to be sold in the reverse exchange.

6. Within 180 days after the transfer of the Replacement Property's ownership to the EAT, the taxpayer's Relinquished Property must be transferred to the purchaser; and

7. The combined time that the Relinquished Property and the Replacement Property are held by the EAT cannot exceed 180 days.

Fortunately, the new safe-harbor Rev. Proc. will permit the parties to enter into appropriate financing arrangements to facilitate the reverse exchange. For example, the taxpayer may guarantee obligations of the EAT, and may loan funds to the EAT to acquire the Replacement Property. Likewise, the EAT may lease Replacement Property to the Taxpayer during the 180 day exchange period, and during this time, the Taxpayer may manage property held by the EAT or supervise any construction of improvements on the property held by the EAT.

7. What if the Taxpayer desires to build Replacement Property?

Example: Taxpayer owns an apartment complex that he wishes to exchange for a vacant lot. He then plans to construct a golf course on the vacant lot. The apartment complex will be sold for $325,000. The Taxpayer needs $100,000 to purchase the vacant lot and $225,000 to complete the improvements for the golf course.

The Taxpayer can still effect a Section 1031 exchange if he allows the sales proceeds to be placed with a qualified intermediary. The vacant lot would be actually acquired by the qualified intermediary and the qualified intermediary would construct the improvements. The Taxpayer would then acquire the improved property from the intermediary. Note that this must be done before the close of the 180 day period. See PLR 9413006. Note also the complicated requirements for identifying Replacement Property to be constructed. Treas. Reg. § 1.1031(k)-1(c)(2)(i).

Sometimes, the building of Replacement Property must be combined with the "reverse exchange" described in 6 above. That is, the client wants to acquire land and construct improvements and later sell his property. In this case, a similar analysis applies. We think that the qualified intermediary must purchase the land and also build the building. Later, after the taxpayer has completed the sale, he can exchange into the land and building then owned by the qualified intermediary. Obviously, this raises many complications.

Care must be taken in identifying property which is to be constructed. The regulations require that the constructed property be identified with particularity and that the property actually receive the "substantially the same property as identified." Reg. § 1.1031(k)-1(e)(3)(ii). It is also important to note that, once property is actually received by the taxpayer, subsequent construction does not "count" towards the exchange. Reg. § 1.1031(k)-1(e)(4).

8. I already have signed a contract to sell my property. Is there anything I can do? Yes. Especially with the qualified intermediary rules, it is still possible to enter into a qualified intermediary agreement and assign the Sales Contract to the qualified intermediary. It would be helpful if a provision allowing this were built into the Sales Contract, but if it is not, the buyer of the property should really not have an objection provided he is delivered good title. However, it is absolutely critical that the qualified intermediary arrangement be entered into before the closing of the client's sale of the Relinquished Property.

9. What if property identified somehow changes before it is acquired? Sometimes, property which is received is not exactly equivalent to that which is identified. For example, where the identification is of a piece of property to be subdivided, the taxpayer may identify what he thinks will be the ultimately subdivided piece of property. However, sometimes the subdivision authority may impose requirements which requires the property to be of a different configuration of that identified.

Under the regulations, the property received must be "substantially the same property identified." In one example in the Treasury Regulations, a fence was erected on identified property between identification and receipt. Reg. § 1.1031(k)-1(d)(2). The example says that because the fence did not alter the basic "nature or character" of the property, it does not affect the identification/receipt issue. However, it is not clear what would happen if more substantial improvements were effected. Suppose, for example, the taxpayer identified a particular acre of land and after the identification a building were constructed on the land?

In another example, two identified acres were reconfigured so that only one and one-half acres were conveyed. Reg. § 1.1031(k)-1(d)(2). In this example, the IRS was OK with the identification because the one and one-half acres was "substantially the same property as identified" because the property received did not "differ from the basic nature or character" of the identified property. Thus, it seems that, for example, a particular shopping center outparcel should be identified and later received as exchange property even if it were later changed. However, it would not be possible to substitute a completely different piece of property.

10. After an exchange, I enter into an agreement to buy property. What should I look out for? As noted above, the contract for purchase of the Replacement Property must be assigned to the qualified intermediary. Therefore, there should be a provision in the Purchase Contract which permits this assignment. Sometimes, sellers may be reluctant to allow an assignment because they don't want the buyer to be able to get "off the hook" in the event the buyer changes his mind.

11. I received a 1099 with regard to property I recently exchanged. How should I handle this? The 1099 should be disclosed on the tax return in order to avoid a problem with IRS matching procedures.

12. What are the reporting requirements? Exchanges should be reported on Schedule D or Form 4797 (which ever is applicable). Also, Form 8824 must be completed. Form 8824 contains information with respect to deferred gain and basis.

13. Now that capital gains rates have been cut, should I still consider doing a Section 1031 exchange? Theoretically, the reduction in capital gains rates will make exchanges slightly less attractive. This is because, in analyzing the exchange, the tax to be paid will be somewhat less so that the exchange is comparatively less favorable. However, taxes on unimproved real estate still represent 25% of the gain and where depreciation recapture is involved, more like 30%. Therefore, we think exchanges will have continued vitality.

14. How can I use a "one-owner" LLC to assist in my exchange? Because a one-owner LLC is disregarded for federal tax purposes, it is logical to assume that a person selling property can exchange into replacement property using a single person LLC to acquire title. This is because if the LLC is ignored, the person will be deemed (for tax purposes) to have acquired the replacement property himself or herself. This was confirmed in a prior IRS Private Letter Ruling, PLR 9807013.

15. Beware of Special Rules Regarding Depreciation Recapture! "Depreciation recapture" under Sections 1245 and 1250 is **not eligible** for Section 1031 tax-free exchange treatment. The tax laws provide complicated rules for determining the amount of "depreciation recapture" **not eligible** for Section 1031 treatment depending upon the nature of the real property involved and the year the property was placed in service. For example, for non-residential real property placed in service after 1980 and before 1987, all accelerated ACRS depreciation is subject to Section 1250 recapture. On the other hand, for residential real property, only the excess of ACRS depreciation over straight-line depreciation is subject to the Section 1250 recapture rules. **Thus, you should contact your CPA to determine whether your real property may be subject to the depreciation recapture rules.**

16. What if I am a partner/shareholder in an entity that owns the real property to be sold? Special Section 1031 problems arise whenever the relinquished property is held in a partnership, corporation or LLC and where not all shareholders or partners of the owner-entity want to engage in a Section 1031 exchange. In these cases, it may not be possible to structure a Section 1031 exchange -- unless ownership of the real property is restructured long before the contract for sale is entered into. Therefore, if the property you want to exchange is held in a partnership, corporation or LLC, you should contact your legal and tax advisors to determine whether you will still be eligible to engage in a Section 1031 exchange transaction.

17. What if I want to acquire a "tenants-in-common" interest in a piece of Replacement Property with another owner? The Section 1031 rules specifically state that Section 1031 tax free treatment does not apply to exchanges of "partnership interests." In some cases, a taxpayer owns a tenants in common interest that will be sold as relinquished property, or wants to acquire a tenants in common interest as replacement property. The question is whether the tenants-in-common ownership arrangement between the taxpayer and the other owner is a partnership or true tenancy. Unfortunately, the Section 1031 exchange rules set forth in the Tax Code do not attempt to define the terms "partnership interest" or the term "tenancy-in-common interest." Instead, tax practitioners who practice in the Section 1031 area are forced to look to other provisions of the Tax Code in order to determine how a court of law might (or might not) construe the Section 1031 prohibition against exchanging property for partnership interests.

To this end, the regulations to IRC Section 761 state that the mere co-ownership and rental of property does not constitute a partnership. However, if the taxpayer anticipates having to also provide repairs, maintenance, cleaning, laundry and other tenant services, these additional services may make the tenancy a partnership, even if these services are provided through a third party management agency. Therefore, you should consult with your tax advisor to determine whether your tenancy interest may be construed to be a tenants-in-common interest or a partnership interest.

IRS Ruling Guidelines on Co-Ownership Arrangements. The IRS may have finally awakened to this issue. In Rev. Proc. 2002-22, the IRS specifies the conditions under which it will consider a request for a ruling that an undivided fractional interest ("UFI") in rental real estate is not an interest in a business entity within the meaning of Reg. 301-7701-2(a). The IRS will not consider a request for ruling under Rev. Proc. 2002-22 unless certain specific information is provided by the taxpayer and all the conditions outlined in the revenue procedures are satisfied.

18. Can I sell my vacation property and defer the gain under Section 1031 and or can I sell my investment property and use the sales funds to buy vacation property in a 1031 exchange? Section 1031 requires that the property sold, and the replacement property purchased, both must be "trade or business" property or property "held for investment" purposes. Thus, nonrecognition under §1031 is premised on the receipt of like-kind property to be held for productive use in trade or business or for investment. Thus, for example, an exchange of investment property for other real estate to be used solely as a personal residence would not qualify. The IRS has taken the position in a letter ruling that such property will qualify as eligible property for purposes of §1031 only to the extent that the taxpayer would have been permitted deductions under §280A. PLR 8508095.

Of course, a taxpayer may own property which he uses partially for investment purposes and partially for personal purposes; for example, a condominium unit in a resort setting might be used by the taxpayer for vacation or personal purposes. In PLR 8103117, the IRS ruled that mere incidental personal use will not taint otherwise qualifying property.

Therefore, if you use your sales proceeds to purchase vacation property, it is possible the IRS will challenge your exchange on the basis that you have purchased "personal use" rather than "investment" property.

a. <u>Barry Moore</u> vs. Commissioners. Recently, in the case of <u>Barry Moore v. Commissioner</u>, TC Memo 2007,-134 (May 30, 2007), the Tax Court considered whether the Moore family could claim Section 1031 treatment on their sale of certain lake front property for other lake front property where both properties were used by the Moores primarily for recreational purposes. In this Tax Court case, Mr. Moore presented evidence at the Tax Court trial that he purchased the relinquished and replacement properties for investment purposes; however, the facts also demonstrated that the Moores used the relinquished and replacement property primarily for recreational purposes. Ultimately, the Tax Court concluded that, although Mr. Moore contended that he purchased the replacement and relinquished property in hopes that those properties would appreciate in value, this was not sufficient to bring the replacement and relinquished properties within the parameters of Section 1031.

Instead, the Tax Court held that, in order for the Section 1031 requirements to be met, the Moores would have to prove that the **primary** purpose of their purchase was to earn rental income or to recognize appreciation in value. Unfortunately, the facts bore out that the Moores purchased and used both properties primarily for recreational purposes rather than for investment purposes. Therefore, the 1031 relief was not available since neither the relinquished property nor the replacement property were held for "primarily" for investment purposes.

b. IRS Safe Harbor for Certain Limited Vacation Use. In early 2008, the IRS issued Rev. Proc. 2008-16 (February 15, 2008) in response to the Barry Moore case, and created a new "safe harbor" for like-kind exchanges of vacation homes and other rental property. The general thrust of the new Revenue Procedure 2008-16 is that the IRS will not challenge a vacation home as qualifying for purposes of Section 1031 (as property held for productive use in a trade or business or for investment) if the home is only occasionally used by the taxpayer for personal use and its predominant use is to generate rental income. The rental income must be bona fide and at fair rental value.

The new safe harbor under Rev. Proc. 2008-16 addresses both relinquished property and replacement property, and the following requirements must be met:

(1) Relinquished property. A dwelling unit that a taxpayer intends to be relinquished property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

(2) Replacement property. A dwelling unit that a taxpayer intends to be replacement property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately after the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

The new safe harbor provides valuable planning opportunities because now we have a "bright line" test for determining whether vacation homes qualify as investment property for Section 1031 purposes. Before the new ruling, clients would often ask:

- “When must I stop using my vacation home before I sell it in a 1031 exchange?"

- "How long do I have to rent the replacement property out before I can convert it to personal use purposes?"

Now, we can answer that the safe answer would be “two years.”

MORE ON SPECIAL ISSUES INVOLVING SECTION 1031 EXCHANGES:

PART ONE
WHEN CAN PERSONAL USE PROPERTY QUALIFY AS SECTION 1031 LIKE-KIND EXCHANGE PROPERTY?

I. <u>Background</u>.

Under Section 1031, both the relinquished property and the replacement property must both be held for productive use in a trade or business or for investment.

Tax practitioners have long wondered whether it may be possible to engage in a Section 1031 Exchange for "dual use" property, such as vacation property at the beach or in the mountains, or even for property used as the taxpayer's primary residence.

Until recent years, we have had very little regulatory or case law guidance to consider.

Cautious and conservative tax advisors have warned that virtually any personal use of the relinquished or replacement property could disqualify the exchange for Section 1031 treatment. Clients, of course, plead their case that they have purchased the vacation property with a hope, and anticipation, that the vacation property would increase in value or would generate rental income, notwithstanding that they also would use the vacation property for personal enjoyment.

II. <u>Tax Court Affirms A Valid 1031 Exchange, Even Though Rental Property Was Soon Converted to a Primary Residence; *Reesink v. Commissioner, TC Memo 2012-118 (April 26, 2012).*</u>

Mr. Reesink owned an apartment building with his brother. The building was sold in 2005, and Mr. Reesink structured his share of the sale as a Section 1031 tax-free exchange. Mr. Reesink used his share of the sales proceeds to purchase a residence on Laurel Hill Lane in a neighboring city using his share of the Section 1031 sales proceeds, as well as funds from a bank loan. On the bank loan application, Mr. Reesink stated that the property was being acquired "for investment purposes."

For the next seven months, Mr. Reesink unsuccessfully attempted to rent the property. Although they never advertised in any local newspapers, the Reesinks posted flyers throughout the town that the Laurel Hill Lane property was available for rent.

The Reesinks owned another primary residence and a trailer that was close to Mr. Reesink's job. Due to financial difficulties, the Reesinks sold their primary residence and moved into the Laurel Hill Lane property about seven months after the sale of the apartment building.

The IRS sought to disallow the Section 1031 exchange on the basis that the Reesink's primary purpose of acquiring the Laurel Hill Lane property was to use it as a primary residence.

Ultimately, Mr. Reesink was able to prevail at trial primarily based upon the testimony of his brother, who testified that the Reesinks had stated that they intended to move to the Laurel Hill Lane area once their children were out of his school. But at that time, Mr. Reesink's son was only fifteen years old and a long way from high school graduation. According to the Court, therefore, at the time the Reesinks acquired the replacement property, they intended to hold it for investment purposes.

III. No Section 1031 Treatment Allowed Where A Married Couple Moves Into Replacement Property Only After Two Months of Attempts to Rent It Out. Goolsby, TC Memo 2010-64 (April 1, 2010).

In Goolsby, TC Memo 2010-64 (April 1, 2010), the married taxpayers owned investment property which they sold and then purchased two (2) pieces of replacement property under a Section 1031 deferred like-kind exchange. Here are the facts:

Mr. Goolsby purchased investment property in 1990. In 2002, Mr. Goolsby signed a contract to purchase property in Pebble Beach, Georgia. However, the purchase agreement obligation was contingent on the Goolsbys' sale of their then current personal residence.

The Goolsbys sold the investment property through IPX, a qualified intermediary ("QI") and the QI used the sales proceeds to purchase both the Pebble Beach property as well as a second property – which was a four-unit apartment building. The Goolsbys then moved in with some relatives and placed advertisements in the local newspaper offering the Pebble Beach property for rent. Two months later, the Goolsbys moved into the Pebble Beach home after not finding any tenants for the Pebble Beach property.

According to the Tax Court, the Goolsbys could not prove that they purchased their Pebble Beach replacement property with any intent to use it for productive use in a business or for investment since they ultimately moved into it in such a short period of time after the purchase. Perhaps one of the most unfavorable facts here was that Mr. Goolsby had asked IPX, the QI, before the sale of the investment property, if he could move his family into the Pebble Beach property, and still qualify for Section 1031 treatment, if he was not able to rent out the Pebble Beach property to a tenant.

Note: The Court also upheld penalties against Mr. and Mrs. Goolsby.

IV. But, Court Allows Section 1031 Treatment for Below Market Rental to Family Member.

In Adams, TC Memo 2013-7 the taxpayer owned a rental home in San Francisco, California. When the tenant left, Mr. Adams exchanged the San Francisco home for another home in Eureka, California, which Mr. Adams then rented to his son at below-market rent. At trial, Mr. Adams explained that he chose the home in Eureka because it was where Bill resided and suited the size of Bill's family. At trial, Mr. Adams testified that he charged below market rent because his son had agreed to, and actually did, remodel and improve the home. The Tax Court held that, even though Mr. Adams had a "personal purpose" for owning the home, the

Eureka home was held "for investment" purposes and therefore qualified as a Section 1031 exchange.

V. <u>Vacation Real Estate: Tax Court Case of Moore V. Commissioner And The "Primarily Held for Investment" Requirement</u>.

A. <u>Overview.</u> The case of <u>Barry Moore v. Commissioner</u>, TC Memo 2007-134 (May 30, 2007) revolved around whether or not the Moore family could claim Section 1031 treatment on their sale of certain lake front property for other lake front property where both properties were used by the Moores primarily for recreational purposes. As discussed further below, although Mr. Moore presented evidence at the Tax Court trial that he purchased the relinquished and replacement properties for investment purposes, the facts also demonstrated that the Moores used the relinquished and replacement property primarily for recreational purposes. Therefore, although Mr. Moore contended that he purchased the replacement and relinquished property in hopes that those properties would appreciate in value, this was not sufficient to bring the replacement and relinquished properties within the parameters of Section 1031.

Instead, the Tax Court held that, in order for the Section 1031 requirements to be met, the Moores would have to prove that the **<u>primary</u>** purpose of their purchase was to earn rental income or to recognize appreciation in value. Unfortunately, the facts bore out that the Moores purchased and used both properties **primarily** for recreational purposes rather than for investment purposes. Therefore, the 1031 relief was not available since neither the relinquished property nor the replacement property were held for "primarily" for investment purposes.

B. <u>Facts of Moore v. Commissioner, TC Memo 2007-134 (May 30, 2007)</u>. In the <u>Moore</u> case, Mr. Moore wanted to exchange vacation property on Clark Hill Lake for other vacation property on Lake Lanier. Originally, the Moores purchased the Clark Hill Lake property in 1988. The Clark Hill Lake property consisted of two adjacent parcels of lake front real property along with a mobile home located on one of those parcels.

Previously, Mr. Moore had bad experiences with the stock market. Mr. Moore produced evidence at trial indicating that he purchased the Clark Hill lake property with the anticipation that it would appreciate in value. At that time, Mr. Moore's personal residence in Norcross, GA was a three hour drive from the Clark Hill property.

The Moores used the Clark Hill Lake property during the summer months on a regular basis. The mobile home located on the Clark Hill Lake property was a double wide mobile home. The Moores built a deck around the house and added a screened in porch and installed a satellite television receiver. They also replaced the roof and painted the home two or three times. They installed a new washer and dryer and replaced some of the furniture.

Until they decided to acquire the Lake Lanier property in late 1999, the Moores never advertised the Clark Hill property for sale although they had received purchase offers. Also, they never rented or attempted to rent the Clark Hill property to others.

On their 1996 through 1999 tax returns, the Moores listed deductions for "home mortgage interest". They did not list on those returns any deductions for **investment interests** <u>nor</u> did they deduct **any maintenance or other expenses** associated with the Clark Hill Lake property.

Later, the Moores moved to Marietta, GA and then the length of commute to the Clark Hill lake property was more like five or six hours. In December 1999, the Moores decided to sell the Clark Hill Lake property and they then entered into exchange agreement through a qualified intermediary and sought to purchase property on Lake Lanier as replacement property. Evidence at trial indicated that one of the primary purposes for moving to the Lake Lanier property was the fact that the Moores changed their primary residence from Norcross, GA to Marietta, GA. Indeed, after the Moores changed their primary residence from Norcross to Marietta, GA, the length of the drive to the Clark Hill property made it inconvenient for the family to spend weekends at the Clark Hill property. As a result, they used that property less frequently.

So, in late 1997 or early 1998, the Moores began to investigate properties on Lake Lanier which is much closer to their Marietta, GA residence. Evidence at trial indicated that the Moores felt that a house on Lake Lanier would be much more use to them than the Clark Hill property. However, the Moores also believed that the property on Lake Lanier would appreciate more readily in value than the Clark Hill property, since Lake Lanier is much closer to Atlanta. So, the Moores purchased the Lake Lanier property in January 2000.

The Lake Lanier property was much more impressive than the Clark Hill property. The Lake Lanier property was a 1.2 acre tract of land and had the largest double slip boat dock allowable on that lake. The new house on Lake Lanier had five screened-in porches and five bedrooms and 4½ bathrooms. The new Lake Lanier property was also fully furnished. After they bought the Lake Lanier home, the Moores visited the home regularly, during each summer.

The Moores deducted substantially all of their home mortgage expense on Lake Lanier as home mortgage interest and a small amount as investment in interest. However, the Moores never took any maintenance or other deduction expenses associated with the Lake Lanier property on their tax returns. Also, the Moores never attempted to rent or sell the Lake Lanier property - until Mr. and Mrs. Moore got divorced and therefore needed to sell the Lake Lanier property to raise liquidity in connection with their divorce.

The IRS challenged the Moores' attempted Section 1031 tax-free exchange of the Clark Hill Lake property for the Lake Lanier property on the basis that the Moores used both properties for their personal use purposes rather than for investment purposes. The Moores, however, contended that they owned both properties with the expectation that both properties would appreciate in value.

In the Moore case, the Tax Court stated that "for investment" under Section 1031 has the same meaning as:

(i) "for profit" for purposes of taking a loss on the sale of property under Section 165(c); and

(ii) "for the production of income" for purposes of taking deductions under Section 212.

The Court then cited the cases under both Section 165(c) and 212 (or their predecessor sections) which held that properties must be held "**primarily** for profit" to take a Section 165(c) loss, or "**primarily** for the production of income" to take deductions under Section 212.

The Tax Court concluded that there was no convincing evidence that the Moores held either property for production of income but instead that there was convincing evidence that the Moores used both properties as vacation retreats. The Moores never attempted to rent either property. In addition, they never attempted to sell either property for a profit. In fact, they did not offer the Clark Hill Lake property for sale until they found the Lake Lanier property. They never attempted to sell the Lake Lanier property until Mr. Moore needed liquidity for his divorce. In fact, they did not offer the Clark Hill Lake property for sale until late 1999 when they decided to acquire the more accessible Lake Lanier property which was closer to their primary residence.

Also, although the Moores made substantial improvements and repairs to both properties, those improvements were more consistent with enjoying the properties as vacation homes. In fact, the improvements made to the Clark Hill Lake property (such as adding a screened-in porch, installing satellite television receiver and such) were more personal use related than designed to increase the value of the Clark Hill Lake property.

Also, with respect to the Lake Lanier property, it was true that the Lake Lanier property represented a substantial investment by the Moores. However, the Tax Court noted that the Moores did not attempt to recover any portion of that investment in the Lake Lanier property by renting the house out or attempting to sell. Also, on their tax return, the Moores treated all of their interest deductions on the Clark Hill Lake property and most of their deductions on the Lake Lanier property as home mortgage interest **rather than as investment interest**.

Thus, the evidence overwhelmingly demonstrated that the Moores' primary purpose in acquiring and owning both the Clark Hill Lake property and the Lake Lanier properties was to enjoy the use of those properties as vacation homes.

The final conclusion of the Tax Court was that "the mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence."

VI. IRS Guidance Provides a "Safe Harbor" for Section 1031 Exchanges of Vacation Real Estate

In early 2008, the IRS issued Rev. Proc. 2008-16 (February 15, 2008) in response to the Barry Moore case and created a new "safe harbor" for like-kind exchanges of vacation homes and other rental property. The general thrust of the new Revenue Procedure 2008-16 is that the IRS will not challenge a vacation home as qualifying for purposes of Section 1031 (as property held for productive use in a trade or business or for investment) if the home is only occasionally used by the taxpayer for personal use and its predominant use is to generate rental income. The rental income must be bona fide and at fair rental value.

The new safe harbor under Rev. Proc. 2008-16 addresses both relinquished property and replacement property, and the following requirements must be met:

(1) Relinquished property. A dwelling unit that a taxpayer intends to be relinquished property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the **greater** of (A) 14 days **or** (B) 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

(2) Replacement property. A dwelling unit that a taxpayer intends to be replacement property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and

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(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

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For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

The new safe harbor provides valuable planning opportunities because now we have a "bright line" test for determining whether vacation homes qualify as investment property for Section 1031 purposes. Before the new ruling, clients would often ask:

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- "How long do I have to rent the replacement property out before I can convert it to personal use purposes?"

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PART TWO
THE PROBLEMS WITH RELATED PARTY EXCHANGES

I. <u>Related Party Like Kind Exchanges and Section 1031(f) Related Party Rules.</u>

Section 1031(f) provides that, if a taxpayer exchanges property with a related person, and within two years after the exchange <u>either</u>

(i) the related person disposes of such property; or

(ii) the taxpayer disposes of the replacement property,

then in either of these events, **<u>both</u>** the taxpayer **<u>and</u>** the related party will have to recognize gain on the exchange (i.e. the exchange in essence will not be tax-free), unless the two exchange parties can establish "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."

A. <u>Who Are "Related Parties"?</u> Section 1031(f) cross-references Section 267(b) and Section 707(b) for a determination of relatedness. The attribution rules pursuant to Section 267(b) provide three types of ownership attribution. Section 267(b) cross-references Section 267(c) for the applicable definitional rules. Pursuant to Section 267(c), a taxpayer may be deemed to own stock held by someone else. Notably absent from the categories of related persons subject to the Section 267 rules is a category for a <u>partnership</u> and its <u>partners</u>. Instead, the rules of Section 707 govern transactions between a partnership and its partners. Section 707(b)(1)(A) provides that "a partnership and a person owning, directly or indirectly, **<u>more than</u>** 50 percent of the capital interest, or the profits interest" are related. Regulation § 1.707-1(b)(3) cross-references Section 267(c)(1), Section 267(c)(2), and Section 267(c)(5) for the necessary relatedness rules regarding constructive ownership. Section 267(c) provides that:

1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
2. An <u>individual</u> shall be considered as owning the stock owned, directly or indirectly, by or for **<u>his family</u>**;
3. An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;
4. The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and
5. Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the

purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

B. 1031(f) Only Applies to "Tax Avoidance" Transactions. Fortunately, Section 1031(f)(2) provides that the related party disqualification rules do not apply where the two exchange parties can establish "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 principal thrust of Section 1031(f) is to reduce the potential for taxpayers to "cash out" an investment in real estate without recognizing gain merely by structuring the disposition as a like-kind exchange with a related party. Congress was concerned that, by doing this, a taxpayer could shift "high basis" from the property the taxpayer wished to retain to low basis property the taxpayer wished to sell. The House Committee Report accompanying the enactment of Sec. 1031(f) recognized that related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The exchange would then position the parties to avoid or substantially reduce the recognition of gain on the subsequent sale.

Of course, Sec. 1031(f) creates a restriction on the disposition of property within two years, but it does not prevent tax deferred exchanges of property between related parties, even if the exchange does create a basis shift, as long as there is no "disposition" within two (2) years.

Therefore, the related party rules of Section 1031(f) **only** will apply where

1. There has been a "disposition" within 2 years of the exchange; **and**

2. There is tax avoidance.

C. What is Income Tax Avoidance? "Cash Outs" and "Basis Shifting."

Sec. 1031(f) is intended to deny nonrecognition treatment for transactions 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 Committee Reports state 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, then the original exchange should not be accorded nonrecognition treatment." (HR Rep. No. 247 101st Cong. 1st Sess. 1340 (1989)).

Unfortunately, Section 1031(f) does not provide much guidance as to when a related party exchange will (or will not) be deemed to be done for tax avoidance purposes. However, when Congress adopted the related parted exchange rules, Congress stated that it is intended that **the non-tax avoidance exception generally will apply to "...(iii) transactions that do not involve the shifting of basis between properties." The Committee Reports on P.L. 101-239.**

D. Classic Tax Avoidance and Basis Shifting/Cash Out Transactions. Here is the classic "basis shifting" and "cash-out" transaction:

> T has property (the "T Property") worth $100 and with a tax basis of $10. Related party R has property (the "R Property") with a tax basis $100 and value of $100. T and R exchange their properties. Now, T owns the R Property with a carryover tax basis of $10, and R now owns T Property with a tax basis of $100. R then sells the T Property for $100 and thus "cashes out" its investment tax free. If Section 1031(f) is deemed to have been violated, then T will recognize $90 of gain when R sells the T Property.

E. "Basis Shifts" and "Cash-Outs" Using a Qualified Intermediary.

Now consider the following facts:

T has property (the "T Property") worth $100 and with a tax basis of $10. T sells the T Property to an outside third party for $100, and T places the sales proceeds with a Qualified Intermediary (the "QI"). The QI then uses the $100 of sales proceeds to purchase replacement property from a related party (the "R Property") within the 180 day exchange period. The R Property has a value of $100 and a tax basis of $100 in the hands of the Related Party.

Here, the Related Party has "cashed-out" its investment in the R Property within two (2) years from the date of the sale of the T Property, since the exchange occurred during the 180 day exchange period. Also, there has been a tax-basis shift which has allowed the Related Party to "cash-out" its investment "tax free." In this case, therefore, the IRS will conclude that T must recognize gain on its attempted Section 1031 exchange.

F. Related Party Private Letter Rulings. Numerous IRS private letter rulings conclude that the Section 1031(f) rules are not violated, notwithstanding a related party exchange involving qualified intermediaries, where there was no cash-out or basis shifting involving either related party. PLR 200706001, PLR 200709036, and PLR 200712013.

G. The Teruya Brothers Case From February 2005; Here, there was no basis shifting, but there was a tax-free cash-out due to the related party's NOL carryovers.

One of most important cases involving related party exchanges is the Tax Court case of Teruya Brothers which came out in February 2005. In that case, the taxpayer engaged in a tax-free exchange with a related party. Teruya Brothers exchanged property with a related party and avoided a tax gain of $1,345,000 on the exchange. The related party then disposed of its 1031 property within two (2) years and recognized a gain of $1,353,000 on the sale of its replacement property.

The IRS took the position that Teruya Brothers should also be required to recognize tax gain of $1,345,000 even though the related party recognized a larger capital gain ($1,353,000) on the sale of its property. **In reality, the related party did not have to pay income tax on its tax**

gain of $1,353,000 because it had a NOL carryforward it could use to offset most of that gain. Therefore, the Tax Court held that the exchange did not meet the 1031 requirements.

In essence, the Teruya Brothers case stands for the proposition that the related party rules will apply where the exchange has a positive tax outcome even if that was not the principal purpose of the exchange. In that case, the related party achieved a great tax result (it was able to cash out its investment with no tax cost) by virtue of the fact that it had an NOL carryforward which it could use to shelter the gain. The Teruya Brothers case also seems to follow the IRS's reasoning in other cases where the related party exchange accomplishes either a "cash out" for one of the parties or and "income tax basis shift" to the other parties.

H. See also Ocmulgee Fields, 132 TC No. 6 (2009) (where the Tax Court held that gain was recognized upon a related party exchange that resulted in "basis shifting".)

PART THREE
IRS Continues to Challenge "Drop and Swap" and
"Swap and Drop" Transactions by LLCs and Partnerships

A. Overview. Recently, the IRS revised the U.S. Form 1065, Partnership Tax Return (which is also used by LLCs), in order to enhance the IRS's ability to attack "drop and swap" and "swap and drop" transactions in Section 1031 exchanges involving partnerships.

Often, an LLC (or partnership) will decide to sell certain real property at a time where one or more of the members (but not all of the members) will desire to do a Section 1031 exchange -- while other members will want to "cash out" their investment. An even more complicated situation arises when the partners (or LLC members) want to go their separate ways and engage in separate Section 1031 exchanges.

In either of these scenarios, we are presented with two hurdles that must be overcome if anyone is to be successful in accomplishing a Section 1031 exchange:

(1) Have the exchange partners met the Section 1031 "held for investment" requirement; and

(2) Will the sale or purchase of a TIC interest be recharacterized as a disqualified attempted Section 1031 exchange of a "partnership interest"?

B. Possible Planning Strategies. So, here are some of the possible options to structure a sale of LLC property to meet the parties' objectives:

1. Structure When Some Partners Want to Stay Together and When Others "Definitely" Just Want to Cash Out.

(a) have the "exchange members" buy out the "cash member" before the exchange for cash

- "but what if the deal falls through?" says the exchange members

(b) have the "exchange members" buy out the "cash member" before the exchange for a promissory note

- "but what if the deal falls through?" says the "cash member"

(c) try to use special tax allocation provisions in the LLC Operating Agreement to specially allocate taxable gain to the exchange member

- but the IRS may argue the "special tax allocation" is invalid because it does not pass the IRS "substantial economic offset test"
- So, add a Tax Reimbursement Agreement into the Redemption Agreement

(d) Redeem the "exchange member" by an in-kind distribution of a TIC interest in the Relinquished Property before the exchange

- The classic "Drop and Swap"
- But the IRS may argue that the exchange members and cash members own the relinquished property as partners

2. <u>Structure When All of the Partners Want to Go Their Own Way and Do Separate Exchanges or "Maybe" Just Cash Out</u>.

(a) If all of the LLC members are fully committed to doing a fully tax-free change, consider

- Having the LLC "exchange" into multiple properties which then will be distributed to the LLC members in liquidation of the LLC
- The LLC "holds" the replacement properties for some time
- After some period of time has passed, the LLC transfers the replacement properties to the LLC members
- The classic "Swap and Drop"

(b) But, if all of the LLC members are **<u>not</u>** committed to doing a completely tax-free exchange, consider

- Having the LLC distribute a TIC interest in the Relinquished Property to the members before the sale
- And, hope we can meet the "held for investment" requirement for the "exchange members"
- And, hope we are successful in arguing that the exchange members do not hold the relinquished property in a de facto partnership

C. <u>Sometimes, the "Drop and Swap" and "Swap and Drop" Are the Only Viable Options</u>. In the past, we all have seen the "drop and swap" or "swap and drop" structure used to attempt to allow the partners to attempt to meet all of their desires. The specifics of the “drop and swap” or “swap and drop” structure will vary – depending upon whether the partnership also owns other property that it is not planning to sell in the near future.

Again, one major requirement of Section 1031(a) is that both the relinquished property and the replacement property both must be “held for" productive use in a trade or business or for investment. And this requirement is the possible problem with both the "Swap and Drop" and "Drop and Swap." There is no definitive time period that the property received must be held, and the issue is one of facts and circumstances. An immediate subsequent taxable disposition of the like-kind property received, however, is strong evidence that the holding requirement was not met. In past rulings, the IRS has indicated that holding of property for 2 years or more is generally sufficient to establish investment purposes of acquiring property. PLR 8429039.

Also, the Section 1031 rules make it clear that a taxpayer cannot secure Section 1031 tax free treatment for exchanges of “partnership interests” for interests in real property. Section

1031(a)(2)(D). In Rev. Proc. 2002-22, the IRS specified the conditions under which it would consider issuing a PLR request for a ruling as to whether a TIC interest in real estate would not be deemed to be an interest in a partnership for purposes of Section 1031. These conditions are often referred to as the 1031 TIC "Safe Harbor" requirements.

Page 3 (Questions 13 and 14) of the new Form 1065 requires taxpayers to disclose whether the partnership, either during the **current or prior** tax year, either (1) distributed any property received in a like-kind exchange or contributed such property to another entity, or (2) distributed a tenancy in common interest or other undivided interest in partnership property.

In light of these new changes to the Form 1065, it is clear that the IRS has not softened its stance with respect to the issue of (i) whether subsequent nontaxable distributions or contributions of like-kind property received in an exchange to another person or entity violates the Section 1031 "held for investment" requirements, and (ii) whether the co-ownership of property (i.e., tenancy in common) will be treated as a disqualified partnership interest if significant services are rendered by the co-ownership arrangement. Again, an exchange of partnership interests does not qualify for nonrecognition treatment under Section 1031(a).

D. The "Held-for" Investment Requirement and the TIC "Safe Harbor". Under the Section 1031 rules, the taxpayer who sells relinquished property must be the identical taxpayer that acquires the replacement property. Second, the relinquished property and the replacement property both must be property that was held by the taxpayer "for investment purposes."

In the past, the IRS has taken the position that, where a taxpayer acquires property shortly before an attempted Section 1031 exchange, the taxpayer has not met the Section 1031 "held for investment" requirement since the sold property was acquired immediately before a Section 1031 exchange. In the past, the IRS has issued rulings stating that, where a corporation or partnership was dissolved prior to the former shareholders or partners engaging in a separate Section 1031 exchange, the former shareholders or partners could not avail themselves of Section 1031 tax-free exchange treatment, since the partners or shareholders (receiving property in kind from the partnership or corporation prior to the Section 1031 exchange) did not meet the "held for investment" requirement under Section 1031.

For example, see Rev. Rul. 77-337. In Rev. Rul. 77-337, the IRS held that the shareholders, who received an in-kind distribution from the corporation, received property from the corporation at a time at which they intended to sell the property and enter into a Section 1031 exchange, and therefore the shareholders did not meet the "held for investment" requirement under Section 1031.

Likewise, in Chase v. Commissioner, 92 TC 874 (1989), the Tax Court accepted the IRS argument that a partner's exchange of partnership property would not meet the Section 1031 requirements. Using the substance-over-form doctrine, the court determined that, although the partnership prepared a deed conveying an undivided interest in the property to the partner, the partner never acted as an owner, never paid any of the property's expenses, never received any of the rents from the property, and was not a party to the contract for the sale of the property. Therefore, the partnership (not the partner) disposed of the property.

Fortunately, however, the tax court has not always sided with the IRS. And, in fact, in some cases the Tax Court has ruled that the" held for investment" requirement could be met - even when property was conveyed to or from a corporation or partnership soon before a Section 1031 exchange. Mason, T. C. Memo 1988 -273 (involving a terminated partnership) and Bolker, 81 T.C. 782 (1983) (involving a terminated corporation).

Likewise, in *Magneson v. Comr.*, 81 T.C. 767 (1953), *aff'd*, 753 F.2d 1490 (9^{th} Cir. 1985), a majority of the Tax Court determined that the taxpayers' exchange of property for a 10% undivided interest in like-kind property qualified for tax-free treatment under §1031(a) where, pursuant to a prearranged plan, the replacement property was contributed to a partnership in exchange for a general partnership interest. The Court ruled that the taxpayers had met the statutory requirement that the replacement property be "held" for investment or for productive use in a trade or business, on the basis that the taxpayers' **relationship** to the acquired replacement property was not changed by the contribution of the replacement property to the partnership, and thus the Court concluded that the "holding" requirement had been met.

The Ninth Circuit affirmed the Tax Court's decision and ruled that the "held for investment" requirement had been met because the general partnership interest was of "like-kind" to the fee interest in the first property. The Ninth Circuit suggested that a different result would be reached if the taxpayers had contributed the second property to a partnership in exchange for a limited partnership interest or had contributed the second property to a corporation in exchange for stock.

Unfortunately, the Chase case was decided **after** Mason, Bolker, and Magneson and therefore we can’t predict whether a court now would follow Chase or the Mason, Bolker and Magneson cases.

However, in *Maloney v. Comr.*, 93. T.C. 89 (1989), the Tax Court held that investment property held by a wholly owned corporation, which was exchanged for other investment property and then distributed to the shareholders in complete liquidation of the corporation, qualified for nonrecognition treatment under Section 1031. The IRS had contended that the exchange did not meet the Section 1031 "held for investment" requirement because the corporation did not hold the property it received for productive use in its trade or business or for investment, as it intended to distribute the property to its shareholders in a liquidating distribution.

Another potential area of Section 1031 controversy is the co-ownership of property (i.e. tenancy in common) and whether such interests will be treated as "partnership interests" where the tenants in common owners render significant services for the property. Under Section 1031(a)(2)(D), a partnership interest does not qualify for nonrecognition treatment under §1031(a). In Rev. Proc. 2002-22, 2002-1 C.B. 733, the IRS has set forth the conditions under which it would consider issuing a PLR request for a ruling as to whether a TIC interest in real estate would not be deemed to be an interest in a partnership for purposes of Section 1031. These conditions are often referred to as the 1031 TIC "Safe Harbor" requirements.

E. <u>The Use of "Drop and Swap" and "Swap and Drop" To Attempt to Accomplish a Section 1031 Transaction for Partnerships (and LLCs)</u>. In the past, many clients have structured Section 1031 exchanges using both the "drop and swap" and the "swap and drop" format. Here is the issue:

1. <u>The Single Asset LLC</u>. If the LLC only owns one piece of property, the tax planner will consider the potential risks of running afoul of the TIC "safe harbor" rules set forth in Rev. Proc. 2002-22, and the tax planner usually will recommend the "drop and swap" format, although some tax practitioners recommend the "swap and drop" structure instead in those cases where the real estate is "serviced" leased property or where the real estate is subject to loan agreements that would cause the loan to become currently due upon a "drop and swap."

a. <u>The "Drop and Swap" For LLC's Owning Non-Serviced Property and Property Not Subject to Mortgage Loans</u>. With the "drop and swap" structure, prior to the sale of LLC property, the LLC will convey a "tenants in common" interest in the property to the "cash" partners (the non-1031 partners) in complete redemption of their interests in the LLC. The LLC will then be owned by only those members desiring to do a 1031 exchange and thus the LLC will retain a tenants in common interest in the real property for the benefit of the LLC members who want to retain their real estate investment. The remaining TIC owners (who were formerly members of the LLC), also will own a TIC interest in the real property. The LLC and the new TIC members (who want to cash out their investment) will then enter into a TIC Agreement that complies with Rev. Proc. 2002-22.

If at all possible, the "drop" will take place before a sales contract is signed. Thereafter, the LLC then sells the property to a third party purchaser and then the LLC (now owned by the LLC members desiring to do a 1031 exchange) will then have their sales proceeds transferred to a qualified intermediary who will then go out and purchase replacement real property which will be acquired by the LLC. The former LLC members (who wish to "cash out") will then sell their TIC interest in the real estate for cash.

With the "drop and swap" technique, the IRS may take the position that, the LLC (which is now owned by the 1031 members) and the non-Section 1031 former members, are all partners in a new partnership such that the LLC is attempting to exchange its partnership interest for real estate, in violation of the Rev. Proc. 2002-22 safe harbor provisions.

<u>LLC Members Who Want to Go Their Separate Ways</u>.

And, things can get real dicey if the Section 1031 members want to do separate Section 1031 exchanges rather than one single Section 1031 for the LLC. In that case, the LLC will distribute TIC interests to all members prior to the sale (and hopefully before the sales contract is signed). In that case, the IRS will have a further argument that the "drop and swap" did not meet the Section 1031 requirements, on the basis that the 1031 members did not "acquire" their TIC interests with the intent to hold it for investment purposes, since those members always intended to Section 1031 exchange the distributed property for new property.

b. <u>The “Swap and Drop” For LLC’s Owning Serviced Property or Mortgaged Property</u>. In other cases of a single asset LLC, it will not be possible to do a “drop and swap”. Consider, for example, a shopping center property which has loan agreement in place which prohibits transfers of the real estate prior to the real estate loan payoff (a “due on sale” clause under the shopping center loan agreement). Also, consider the same case of a shopping center which is owned by the LLC and that has “service” related leases that will violate the safe harbor provisions of Rev. Proc. 2002-22. In these cases, it may not be possible to do a “drop and swap” prior to the sale.

In these cases, the LLC may have to proceed with a 1031 transaction with the entire LLC. In this case, the LLC will sell its real estate for cash and for other 1031 property (albeit, through a qualified intermediary).

Prior to the sale, the LLC Members will amend their LLC Operating Agreement so as to attempt to “specially allocate” all of the taxable gain (attributable to the cash non-1031 proceeds) to the cashing out members pursuant to the special allocation rules of Section 704, and this LLC Operating Agreement amendment (relating to this special Section 704 allocation) will have to be signed before April 15 of the next tax year to comply with the Section 704 special allocation rules. The Members may also agree to sign a Tax Reimbursement Agreement, under which the “cashing out” members will agree to reimburse the LLC for any taxes reallocated to the Section 1031 members.

After the sale, the LLC will be left with Section 1031 replacement property as well as “taxable cash” and the LLC will then distribute its taxable cash to the non-Section 1031 members who do not wish to do a Section 1031 exchange. Under the terms of the amended LLC Operating Agreement, the non-Section 1031 members (who did not wish to do a Section 1031 exchange) will be specially allocated all of the taxable gain which has been specially allocated to them.

Nevertheless, the IRS may take the position that any such special allocations (of the taxable gain attributable to the cash non-1031 proceeds to the cashing out members) do not have “substantial economic effect” under the Section 704 Regulations if the special allocations of taxable gains will not be appropriately matched with their capital accounts, and thus the special allocations could fail the “substantial economic effect” test under the Section 704 rules. This could be particularly true in those cases where the cash-out partners have less taxable gain to recognize upon the sale than the partnership would otherwise recognize upon a completely taxable sale (because the cash partners have a higher tax basis in their partnership interests) and thus the amount of gain recognized by the partnership may exceed the gain which would be allocable to the retiring/redeemed partner upon a sale of the partnership property.

In that case, if the IRS is successful, the LLC (and the Section 1031 members) will still be left with taxable gain to recognize even after the Section 1031 exchange - although a Tax Reimbursement Agreement may partially fix this problem presuming that the cashed out non-Section 1031 members are able (and willing) to reimburse the LLC for any taxes paid as a result of an IRS audit.

Furthermore, if not all of the Section 1031 members want to do a collective exchange, they will then have to distribute the replacement properties to themselves and in that case, the IRS will have a further argument that the "swap and drop" did not meet the Section 1031 requirements, on the basis that the LLC did not "acquire" its property interest with the intent to hold it for investment purposes, since the LLC always intended to distribute its property interest to the Section 1031 members.

2. <u>An LLC that Owns Multiple Properties: the "Drop and Swap"</u>. Things get a lot more complicated where the partnership owns multiple properties, and where only one property is to be sold.

In this case, the LLC may have no choice but to distribute (to the 1031 partners **<u>and</u>** the non-1031 partners) a tenants in common interest in real property to be sold, again unless the real estate is "serviced" leased property or where the real estate is subject to loan agreements that would cause the loan to become currently due upon a "drop and swap."

The 1031 members will then own a tenants in common interest in the property to be sold (with the non-1031 members) and the 1031 members will then do their own Section 1031 exchange.

With this structure, the IRS still has the same arguments - first, that the distributee 1031 members are now partners in the new partnership (with the non-1031 members) and that the distributee LLC members are simply trying to exchange their partnership interests for other real estate. To make matters worse, the IRS also has an additional argument that the distributee LLC members did not "acquire" the relinquished 1031 property interest with the intent to hold it for investment purposes" since a sale was contemplated..

In these cases, we may try the following approach:

(i) Do the "drop" before the sales contract is signed;

(ii) Have all of the Section 1031 Members and Non-Section 1031 members sign a TIC Agreement that meets the Rev. Proc. 2002-22 safe harbor;

(iii) Have all of the LLC Members enter into a Special Tax Allocation Agreement;

(iv) Have the non-1031 members enter into a Tax Reimbursement Agreement in favor of the Section 1031 members.

IV. **Conclusion**.

This Article provides some of the basic rules for understanding like-kind exchanges.

However, you should note that, although the IRS has issued some fairly specific regulations, there are still many issues which are unresolved. These regulations have only been around since 1991 which is a very recent year in the tax world. This means that there are virtually no cases or rulings which provide additional guidance on like-kind exchanges. Therefore, no one can predict what the IRS might argue on audit or how the IRS or courts might rule in the future.

Of course, you should feel free to call anyone at Carruthers & Roth, P.A. if you have a question or concern about your like-kind exchange at any time.

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