Vesting and Finance Issues Related to Tax-Deferred Exchanges Under IRC § 1031

Todd R. Pajonas

How unique purchasing and financing requirements can affect the structure of an exchange transaction.

Since 1921, taxpayers have had the option of deferring the recognition of capital gains tax by exchanging real property, rather than engaging in a sale and subsequent purchase. Although tax-deferred exchanges have been possible since 1921, it was not until the now famous decision in *Starker v. United States*,[1] which provided for exchanges on a delayed, rather than simultaneous basis, that exchanges became a popular means of shielding taxpayers from the recognition of capital gains tax. Although much has changed since 1921, the basic concept remains: A properly structured tax-deferred exchange under Section 1031 of the Internal Revenue Code of 1986, as amended, allows an owner of real property, the Exchanger, to defer the recognition of capital gains tax normally recognized on the sale of real property, if the exchanger buys a like-kind property of equal or greater value and uses all of its cash equity in the subsequent purchase.

Like-Kind Requirement

In order to qualify for exchange treatment, the properties to be exchanged must be of like-kind. "Like-kind property" is defined as property held for productive use in a trade or business, or for investment purposes, that is exchanged for property that is to be held for productive use in a trade or business, or for investment purposes.[2] Like-kind refers to the nature or character of the property, "[t]he fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class."[3] All real property conforming to this definition will be considered like-kind. For example, a four-unit apartment building, which is held for investment purposes, can be exchanged for industrial property held for business purposes.

There is no requirement that properties be similar in type or class. Although personal property fitting the above definition of "like-kind" may also be exchanged, *real prop-*

erty must be exchanged for real property, and personal property must be exchanged for personal property. Real property and personal property are not *like-kind* to each other. The determination as to what is considered real property and what is considered personal property is generally determined by state law.[4] In addition, the IRS opined in Revenue Ruling 55-749 that state law controls the characterization of property interests for the purposes of IRC § 1031.

Types of Exchange Structures

There are four basic types of tax-deferred exchange structures: simultaneous, delayed,[5] reverse, and build-to-suit. In the most common variant of a simultaneous or delayed exchange, the exchanger generally enters into a contract to sell its property or properties in an arms-length transaction. A person or entity that is not a disqualified party pursuant to Treasury Regulation § 1.1031(k)-1(g)(4)(iii), usually a Qualified Intermediary, thereafter assigns into the rights, but not the obligations of said contract. This person or entity is variously called an "accommodator," "intermediary," "straw-man," or "facilitator."[6] Regardless of the name, this person or entity will merely act as the conduit through which the property passes. In addition to and simultaneous with the assignment of contract, the exchanger enters into an exchange agreement with the intermediary.

Same-Taxpayer Requirement

An issue that is important when financing the acquisition of replacement property is the requirement, although not clearly expressed in IRC § 1031, that the taxpayer disposing of relinquished property must be the same taxpayer to acquire the replacement property. IRC § 1031(a) defines like-kind property as "property *held* for productive use in a trade or business, or for investment purposes." Most tax advisers will argue that when a taxpayer has received an interest in property as part of a distribution or dissolution from an entity in which he/it had an interest, such as a partnership or corporation, immediately prior to selling the property, the taxpayer will not satisfy the "held for" requirement of IRC § 1031. Instead, the taxpayer will be deemed to have held that property for resale, since it was the prior entity that truly held it for business or investment purposes.

At odds with the requirement of keeping the same taxpayer on both sides of the transaction is a lender's requirement, in many cases, for taxpayers to acquire real property in bankrupt remote entities. The question then arises: What form of bankrupt remote entity will allow a taxpayer to complete a tax-deferred exchange?

In *Delwin G. Chase and Gail J. Chase v. Commissioner of Internal Revenue*,[7] the court held that an attempted exchange, in which a partnership distributed to two partners their interest in real property owned by the partnership right prior to the sale of said property, did not qualify for exchange treatment because the real party exchanging the property was the partnership. Although *Chase* is often cited as requiring the same taxpayer to dispose of the relinquished property and to acquire the replacement property, the court considered other factors, including the taxpayer's failure to negotiate on behalf of themselves; their failure to pay their portion of the broker's fees; and the fact that, in apportioning the net sales proceeds, the taxpayers were treated as partners, rather than direct owners. In citing these factors as reasons for denying exchange treatment, the court seems to have left the door open for a deviation from the same-taxpayer rule.

A good example of a deviation from the same taxpayer rule can be found in TAM 199907029, wherein each of the four members of a general partnership entered into their own exchange agreement with an accommodator to dispose of property owned by the partnership. Thereafter, one of the partners failed to identify replacement property within 45 days and had his portion of the exchange funds returned to him. As a partner, his receipt of these funds should have voided the exchange on behalf of the entire partnership. However, the IRS found that the separate exchange agreements of each partner satisfied the requirements of Treasury Regulation § 1.1031(k)-1(g)(3), providing for protection of actual or constructive receipt through the use of a qualified escrow account. Thus, the use of a separate exchange agreement allowed the one partner to receive a distribution, without affecting the partnership's ability to complete the exchange and, in effect, disregarding the partnership that had been in existence for more than 20 years. The partnership was ordered to recognize a gain on the amount of the distribution to the one partner, but the IRS did not rule this as a violation of Treasury Regulaltion § 1.1031(k)-1(g)(6)(i).

Single-Member LLC

Alternate forms of ownership on the purchase side of a tax-deferred exchange, which are required when a lender wishes to shield its security interest in the replacement property in a bankrupt remote entity, are now generally less problematic than the above partnership scenario. The most common form of ownership in a new entity is the single-member limited liability company (LLC). In addition to a single-member LLC, there are other so-called pass-through entities that are disregarded by the IRS as an entity separate from the taxpayer, such as a Delaware business trust, a Massachusetts nominee trust, an Illinois land trust, and grantor trusts. Other examples, such as subsidiaries of corporations or new corporations formed by mergers or acquisitions of other corporations, can also provide for different parties on each side of an exchange.

In the case of single-member LLCs, the initial question has always been whether taking title in the name of the new LLC would be characterized as a partnership or beneficial interest, therefore falling under one of the exclusions enumerated in IRC § 1031(a)(2). In general, an entity with only one owner will be classified either as a disregarded entity or a corporation, whereas an entity with two or more members will be classified as a partnership or a corporation. Accordingly, an entity with only one member that does not elect to be treated as a corporation will be treated as a disregarded entity. This allows a taxpayer to take title in a new entity, fulfilling a lender's requirement, without jeopardizing the viability of the exchange.[8] A classification change can be accomplished by an eligible entity by filing Form 8832 - Entity Classification Election.[9] A classification change can be effective up to 75 days prior to or 12 months after the date on which the election is filed. However, the entity may not make any more classification elections within 60 months after the effective date of the classification.[10]

Land Trust

Another example of a deviation from the same-taxpayer rule is the land trust, such as the Illinois land trust. Generally an interest in a trust falls under the exclusions of IRC § 1031(a)(2). However, the IRS has taken the position that an interest in a land trust, where the land trust agreement provides, among other things, that the taxpayer, as beneficiary of the trust, retains exclusive control of the management, operation, renting and selling of the real property, will be treated as an interest in real property.[11] As long as the taxpayer has all the burdens and benefits of ownership, the trust will not give rise to a trust relationship for federal tax purposes.

This ruling also applies to land trusts created under the laws of other states, such as California, Florida, Hawaii, Indiana, North Dakota, and Virginia, provided that:

- The trustee has title to real property;
- The beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee in dealing with the title to the property; and
- The beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.

This ruling does not apply to real estate investment trusts (REITs).[12]

However, if the land trust agreement has multiple beneficiaries and contains language similar to that found in a partnership agreement, the trust could be recharacterized as a partnership.[13] This is true not only for land trusts, but wherever multiple owners have an agreement covering the relationship between the parties.

Corporate Mergers

In the case of a corporate merger, where it is classified as tax free under IRC § 368(a)(1)(A), the surviving corporation will gain the benefit of the acquired corporation's tax positions as defined in IRC § 381(c). Although IRC § 1031 is not mentioned specifically in IRC § 381(c), the IRS has ruled that the surviving corporation may take title to the replacement property, where the acquired corporation originally started the exchange, without adversely affecting the exchange.[14] In addition, the IRS has allowed an exchange combining a liquidation of a subsidiary with the formation of a new single-member LLC. In Private Letter Ruling 9751012, a wholly owned subsidiary of a corporation disposed of a relinquished property and then liquidated into the parent corporation pursuant to IRC § 332. The parent corporation thereafter formed a new single-member LLC, of which the parent com-

pany was the sole member. This new LLC completed the exchange by acquiring the replacement property. The IRS reasoned that the liquidation qualified for an IRC § 381(c) attribute carryover, allowing the parent company to step into the shoes of the former subsidiary, coupled with the formation of a new single-member LLC by the parent company, which LLC is disregarded as a separate entity.[15] This structure most likely would come to fruition where a lending institution would like to have the strength and security of a larger parent company as the debtor, rather than a smaller subsidiary, but would still like the newly acquired replacement property to be held in a bankrupt remote entity.[16]

Industrial Development Authorities

Another unique situation involving financing the acquisition of real property is the Industrial Development Authority (IDA). IDAs are creatures of state statute, commonly used by municipalities to provide a benefit and incentive to parties seeking to invest in real property. Structuring an acquisition of real property in conjunction with an IDA usually results in, among other things, a lower interest rate on the financing and an exemption from real property and personal property taxes. When a taxpayer purchases a property in conjunction with an IDA, it is the IDA that acquires the property on behalf of the taxpayer, with construction and/or improvements being financed by the IDA. Typically, the property is then "triple net" leased to the taxpayer. The problem for a taxpayer desiring to do an exchange into or out of an interest in an IDA property is whether the taxpayer's interest will qualify as an interest in real property to be used in an exchange.

There are two schools of thought as to whether the taxpayer's property should be considered an interest in real property: (1) the taxpayer's leasehold interest has 30 years or more, including renewal options, left to run; or (2) pursuant to state law, the IDA's ownership of the property is not considered a true real property interest, but merely a financing arrangement. In the first example, Treasury Regulation § 1.1031(a)-1(c) provides that a leasehold interest with 30 years or more left to run, including renewal options, will be considered an interest in real property, which may be exchanged for any other like-kind property. This is often helpful when exchanging into the IDA property, where the initial term of the lease may be applicable to this qualification.

However, it is the second example that most often comes into play when a taxpayer wishes to exchange out of an IDA-financed property and there is less than 30 years remaining on the lease including renewal options. In *Davidson Pipe Supply Co. v. Wyoming County Industrial Development Agency*,[17] the court, quoting from a lower court ruling, stated:

> The conveyance of legal title to the agency with simultaneous lease back to the company is structured merely as a mechanism to facilitate financing and is not a genuine allocation of ownership in the agency. The economic benefits and burdens of ownership are reserved to the company and the agency serves only as a conduit for the tax benefits provided by such an arrangement . . . .

Inasmuch as New York State law classifies the interest of the IDA in the subject property as merely a form of financing, it is clear that the equitable interest of the taxpayer in the property rises to a true interest in real property, which can be exchanged for like-kind property.

Real Estate Investment Trusts

Another type of problem arises when a taxpayer went to exchange into or out of an interest in a REIT. Generally an interest in a REIT will be considered a security, and thus fall into the exclusions enumerated in IRC § 1031(a)(2). However, if structured properly, there are alternatives for taxpayers wishing to do these types of exchanges. An owner of real property can contribute real property to an "UPREIT" or "DOWNREIT" pursuant to IRC § 721. However, many times a REIT is not interested in property currently owned by the taxpayer but wishes the taxpayer to exchange into new property, which the REIT identifies, and then has the taxpayer contribute that new property into the REIT. Problematic to this structure is whether that taxpayer will have been deemed to have held the property for business or investment purposes, or only for resale to the REIT.[18]

As an alternative to contributing newly acquired replacement property to an UPREIT, the taxpayer will be given a right to place the property with the UPREIT after a year or more, as a "put," and the UPREIT will have the option, after a year or more to acquire the property, as a "call," in exchange for UPREIT units. The problem with this structure is whether these options will run afoul of

the rules expressed in *Magneson v. Commissioner*.[19] In *Magneson*, a taxpayer exchanged into replacement real property and, thereafter, immediately contributed that property to a partnership, in exchange for a general partnership interest. The court ruled that *Magneson* did not hold the property for business or investment purposes pursuant to IRC § 1031(a).

In the instant case, the structure of the "put" and "call" give the taxpayer and the UPREIT the right, but not the obligation, to complete the placement of the real property into the UPREIT. By structuring the transaction in this way, taxpayers can attempt to avoid the problems of *Magneson* by not contributing the real property right after completing the exchange. However, the IRS could view these steps as an integrated whole under the so-called step transaction doctrine, in which case the IRS would characterize the transaction complete upon the mutual "put" and "call" agreement, in violation of *Magneson*. However, since neither party is obligated to complete the transaction, it would seem to be difficult for the IRS to characterize the transaction in this way. Although this is a very general overview of structuring an exchange of property into an UPREIT, it would appear that a transaction of this type is a viable alternative to realizing a capital gains tax for investors wishing to "exchange into" a REIT.

Conclusion

It appears that the requirements of lenders for bankrupt remote entities, coupled with various types of unique financing arrangements, have resulted in new interpretations of the requirements for completing a viable IRC § 1031 tax-deferred exchange. As the trend toward securitization of real property continues, it is possible that there will be even more unique examples as to what will be permitted in the future. ■

Notes

[1] 602 F.2d 1341, 44 A.F.T.R.2d 79-5525, 79-2 USTC P 9541 (9th Cir. 1979).
[2] IRC § 1031(a)(1).
[3] Treas. Reg. § 1.1031 (a)-1(b).
[4] Treas. Reg. § 1.1031(a)-1(b), (c), Aquilino v. United States, 363 U.S. 509, 80 S. Ct. 1277, 5 A.F.T.R.2d 1698, 60-2 USTC P 9538 (1960); Coupe v. Commissioner, 52 T.C. 394 (Tax Ct. 1969), acq. in result, 1970-1 C.B., acq. in result, 1970-2 C.B.
[5] Treas. Reg. § 1.1031(k)-1(a).
[6] Treas. Reg. § 1.1031(k)-1(g)(4).
[7] 92 T.C. 874 (1989).
[8] Treas. Reg. § 301.7701-2(c).
[9] Treas. Reg. § 301.7701-3(c)(1)(i)
[10] Treas. Reg. § 301.7701-3(c)(iv); Wright, "Disregarded Entities in Corporate Transaction," 449 PLI/Tax 137 (Oct.–Nov. 1999).
[11] Rev. Rul. 92-105, 1992-2 C.B. 204.
[12] Long & Vrbanac, Tax-Free Exchanges Under § 1031, ch. 9 (Clark Boardman Callaghan 1998).
[13] Priv. Ltr. Rul. 8113078 and 8346089. Clark Boardman Callaghan.
[14] Priv. Ltr. Rul. 9252001 and 9152010. Clark Boardman Callaghan.
[15] Treas. Reg. § 301.7701-3(a).
[16] Schechtman & Schachat, "Corporate Planning Opportunities: Exchanges in Consolidated Groups Among Affiliates and Synthetic Leases," Hotel Del Coronado Presentation (Oct. 22-23, 1998).
[17] 648 N.E.2d 468, 85 N.Y.2d 281, 624 N.Y.S.2d 92 (1995).
[18] IRC § 1031(a).
[19] 753 F.2d 1490 (9th Cir. 1985).