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Like-Kind Exchanges

Marc Finer of Murtha Cullina LLP discusses the IRS's refusal to acquiesce to the U.S. Tax Court decision in Estate of Bartell v. Commissioner in which the court found that there was a valid like-kind exchange when the replacement property was parked for 17 months without the facilitator having traditional benefits and burdens of ownership.

IRS Refuses to Acquiesce to 'Estate Of Bartell' Decision on Non-Safe Harbor Reverse Like-Kind Exchanges

BY MARC T. FINER

In *Estate of George H. Bartell, Jr. v. Commissioner*, the U.S. Tax Court upheld the validity of taxpayer's non-safe harbor reverse like-kind exchange under Internal Revenue Code Section 1031. The Tax Court came to this decision notwithstanding that the third party facilitator used to assist with the exchange did not acquire the benefits and burdens of ownership of the replacement property prior to the time the replacement property was transferred to the taxpayer to complete the exchange. Practitioners viewed the *Bartell* decision as noteworthy because it seemed to indicate that the ''benefits and burdens'' analysis historically applied by the Internal Revenue Service in this type of exchange was no longer a critical element in determining the validity of non-safe harbor reverse exchanges.

Background on Reverse Section 1031 Exchanges Code Section 1031 provides, in part, for the nonrecognition of gain or loss on the non-simultaneous exchange of property held for productive use in a trade or business or for investment for like-kind property (commonly referred to as a ''forward like-kind exchange''). However, neither the Internal Revenue Code nor the Treasury Regulations address the situation in which the replacement property is acquired before the taxpayer can sell its relinquished property (commonly referred to as a ''reverse like-kind exchange''). Recognizing the need for guidance, the IRS issued Revenue Procedure 2000-37, which permits the taxpayer to ''park'' the replacement property with a third party exchange facilitator before disposing of the relinquished property. Rev. Proc. 2000-37 states that the IRS will not challenge the treatment of the facilitator as the beneficial owner of the property for tax purposes if all of the requirements of the Rev. Proc. 2000-37 are satisfied. One of these requirements is that the taxpayer sell the relinquished property and receive the replacement property from the facilitator within 180 days of the date the facilitator acquires (i.e., ''parks'') the replacement property. Rev. Proc. 2000-37 is effective for exchanges on or after Sept. 15, 2000.

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The Bartell Case In *Bartell*, the Tax Court was asked to decide whether a reverse exchange qualified as a valid like-kind exchange (LKE) where the replacement property was parked for 17 months without the facilitator having traditional benefits and burdens of ownership. Rev. Proc. 2000-37 was inapplicable because the LKE in *Bartell* commenced prior to the effective date.

The IRS's long-standing position is that if a reverse LKE does not comply with the requirements of Rev. Proc. 2000-37, the facilitator must acquire the traditional benefits and burdens of ownership of the replacement property, rather than bare legal title, for the transaction to qualify as a valid reverse LKE. Consistent with this position, the IRS asserted in *Bartell* that the transaction did not qualify as a valid reverse LKE because the facilitator did not assume any of the benefits and

burdens of ownership of the replacement property during the time it held title. The IRS noted that the facilitator had no equity interest in the replacement property, made no economic outlay to acquire the property, paid no real estate taxes, the taxpayer financed and supervised construction on the property and the taxpayer had possession and control of the property for the entire time the facilitator held title. In contrast, the IRS contended that the taxpayer already owned the replacement property under the benefits and burdens test because it had ''. . . the capacity to benefit from any appreciation in the property's value, the risk of loss from any diminution in its value, and the other burdens of ownership such as taxes and liabilities arising from the property.''

Based on favorable taxpayer case law in the U.S. Court of Appeals for the Ninth Circuit (to which an appeal of the Tax Court's decision would be heard), the Tax Court held that the facilitator was not required to assume the benefits and burdens of ownership of the replacement property in order to be treated as its owner for Section 1031 purposes and that the transaction qualified for nonrecognition treatment as a reverse LKE.

IRS Action on Decision On Aug. 14, 2017, the IRS issued an action on decision, AOD 2017-06 (Aug. 23, 2017) stating that it was not acquiescing to the *Bartell* decision. Specifically, the AOD stated that for transactions outside the scope of Rev. Proc. 2000-37, the IRS would not follow the principle in *Bartell* that an exchange facilitator may be treated as the owner of the replacement property regardless of whether it possesses the benefits and burdens of ownership. The IRS's position continues to be that a taxpayer that uses an exchange facilitator outside the scope of Rev. Proc. 2000-37 has not engaged in a LKE if the taxpayer, rather than the exchange facilitator, possesses the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. In other words, for a LKE outside of the safe harbor, ownership by the exchange facilitator will not be presumed.

The AOD makes it clear that the IRS will continue to scrutinize and potentially litigate reverse LKEs outside of the Rev. Proc. 2000-37 safe harbor where it believes the exchange facilitator does not acquire the traditional benefits and burdens of ownership of the replacement property. Therefore, it is important for taxpayers to consult with their tax advisors to structure their reverse exchange transactions in compliance with Rev. Proc. 2000-37 to avoid contending with the uncertainty of how the IRS would examine the transaction. Taxpayers in the Ninth Circuit, however, can use the favorable case law cited in *Bartell* to argue that a facilitator with title to the replacement property should be treated as the owner of the replacement property before the exchange is completed regardless of whether the taxpayer has the benefits and burdens of ownership.

Even without the issuance of the AOD, many LKE accommodators will agree to act as the facilitator in a reverse LKE only within the parameters of the safe harbor provisions of Rev. Proc. 2000-37. However, there are LKE accommodators that will agree to accept a portion of the burdens of ownership of the replacement property (i.e., acquire a meaningful at-risk equity investment in the replacement property) in a non-safe harbor reverse LKE for an increased fee.

Tax Reform The legislation known as the Tax Cuts and Jobs Act, which Congress recently passed and which President Trump signed into law (Act), lowers corporate and individual tax rates and temporarily provides 100 percent immediate expensing of certain depreciable personal property assets and real estate improvements. To offset the loss of tax revenue resulting from these changes, the Act limits the definition of ''property'' for like-kind exchanges to ''real property'' for transfers that commence after Dec. 31, 2017.

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