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Recent Developments in 1031 Exchanges

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Reverse Exchanges and the "Benefits and Burdens" Requirement

1. *Estate of George H. Bartell, Jr. v. Commissioner*

Estate of George H. Bartell, Jr. v. Commissioner, 147 T.C. 140 (6/10/2016) involved an "exchange last" parking arrangement among the taxpayer, a qualified exchange intermediary ("QI"), and an exchange accommodation titleholder ("EAT"). The facts are as follows:

In 1999, Bartell Drug Co. ("Bartell"), an S corporation, entered into an agreement with an EAT to purchase a parcel of land upon which Bartell intended to build a new drugstore ("Replacement Property"). However the Replacement Property was found by the taxpayer before Bartell had identified a buyer to purchase Bartell's currently owned property ("Relinquished Property"). Additionally, Bartell needed to purchase the Replacement Property with improvements on the property in order to defer the entire gain from the sale of the Relinquished Property.

Bartell arranged through a QI to purchase the Replacement Property, while transferring the title of the property to an EAT. The EAT also agreed to build improvements on the property subject to the supervision and management of Bartell. The EAT obtained financing arranged by Bartell from a bank to fund the purchase of the Replacement Property and to pay for the improvements. The loan was guaranteed by Bartell and was nonrecourse to the EAT. Lastly, the written agreement between the taxpayer and the EAT expressly gave the taxpayer the right to purchase the Replacement Property from the EAT within 24 months for the EAT's cost of acquiring and improving the property. After construction of the new drugstore was completed, the EAT leased the Replacement Property to Bartell until the Relinquished property was sold, completing the section 1031 Exchange nearly 17 months after the EAT acquired legal title to the Replacement Property.

On audit, the IRS asserted that the exchange failed to qualify under Code Section 1031 on the ground that Bartell was actually the owner of the Replacement Property well before the time when the EAT transferred the Replacement Property by deed to the Bartell. The IRS contended that the EAT must acquire the traditional "benefits and burdens" of ownership of a "parked" replacement property in order to facilitate a section 1031 exchange for a taxpayer. In August of 2016, ten years after the original briefs were filed in the case, the Tax Court issued a final ruling in favor of Bartell.

The Tax Court rejected the IRS' argument that an EAT must assume the benefits and burdens of ownership of a "parked" replacement property in order to facilitate a §1031 exchange.

Relying on case law from both the Ninth[1] and Fifth[2] Circuit, the Court reiterated that a taxpayer may engage an EAT to acquire title to, and "park," a replacement property solely for the purpose of a section 1031 exchange. Additionally, the Court distinguished *DeCleene v. Commissioner*, 115 T.C. 457 (2000), another Tax Court case relied on by the IRS in support of the application of the "burdens and benefits test." In *DeCleene*, the court used a benefits and burdens analysis to determine that the taxpayer had beneficial ownership of the replacement property at the time of the exchange, even though he had arranged for the transfer of legal title to the replacement property to the purchaser of his relinquished property. Here, the Court distinguished *DeCleene* on the ground that the taxpayer in *DeCleene* held its purported replacement property for over a year before transferring it to a buyer, as well as the fact that the taxpayer failed to use a third-party exchange facilitator. Ultimately, the Tax Court held that Bartell's exchange will qualify for nonrecognition of gain or loss under Section 1031 provided that the EAT was not acting as the "agent" of the taxpayer at the time the taxpayer acquired legal title to the "parked" property.

The implications of *Bartell* are interesting in light of the fact that the transaction predated the effective date of Rev. Proc. 2000-37, which establishes a safe-harbor for reverse exchange "parking arrangements" not exceeding 180 days. The taxpayer's victory in *Bartell* suggested that the normal analysis of burdens and benefits of ownership were inapplicable in determining the validity of a non-safe harbor reverse like-kind exchange. The Court even supported its holding with Rev. Proc. 2000-37, noting the "no inference" language regarding parking transactions outside the safe harbor, as well as the lenient standards provided by the IRS under the safe harbor. Thus, in applying the form over substance doctrine, the court in Bartell provided for a lenient approach to transactions structured to qualify under Section 1031, including allowing improvements constructed on replacement property to qualify as replacement property.

However, although the IRS did not appeal *Bartell*, The IRS issued a non-acquiescence in an Action on Decision, IRB 2017-33 (August 14, 2017). The non-acquiescence related to "the holding that a taxpayer's sale and acquisition of business property qualifies as a like-kind exchange under section 1031 even though 17 months before the purported exchange, an accommodating party facilitating the transaction acquired title to the replacement property and the taxpayer acquired the benefits and burdens of ownership of the property." Accordingly, the IRS still holds that, for taxpayers using accommodating parties outside the scope of Rev. Proc. 2000-37, the taxpayer cannot acquire the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property.

2. *New York Real Estate Transfer Tax*

In Advisory Opinion No. TSB-A-16(2)(R) (12/07/16), the New York Department of Finance and Revenue assessed the real estate transfer tax ("RETT") consequences of certain aspects of reverse exchanges. The Department was concerned with the consequences of conveyances of real property from an EAT to an exchanging taxpayer in the process of completing a safe-harbor reverse exchange under Rev. Proc. 2000-37. In this particular case, the agreement

[1]Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963).

[2]Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980).

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