

Ins and Outs of Like-Kind Exchanges

Presented by:

**James R. Browne
Strasburger & Price L.L.P.
Dallas, TX**

Speaker



JAMES R. BROWNE

Jim is a partner in the Dallas office of **Strasburger & Price, LLP** law firm, specializing in general tax planning. He has over 30 years of experience in the area of taxation, having served as lead counsel in matters involving federal, state, and foreign taxes. He regularly advises clients on the U.S. income tax aspects of domestic and international business transactions involving a diverse range of industries, including healthcare, manufacturing, energy, real estate, and financial services.

Prior to joining Strasburger in 2005, Mr. Browne served as chief tax officer for several large publicly traded multinational companies, was a partner in a "Big 4" accounting firm, and was a partner in a nationally prominent law firm.

He earned his law degree from Vanderbilt University (1981) and his undergraduate degree in business administration from the University of Michigan (1978). He is a licensed lawyer and certified public accountant in Texas.

Strasburger & Price, LLP
901 Main Street, Suite 4400
Dallas, Texas 75202.3794
Tel: 214.651.4420
Fax: 214.659.4019
jim.browne@strasburger.com

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Agenda

- **Overview**
- **Exchange Requirement**
- **Like-Kind Requirement**
- **Held for Requirement**
- **Partnerships and Disregarded Entities**

Overview

Overview

- **General rule - §1031(a)**

- “No gain or loss shall be recognized on the *exchange* of property held for productive use in a trade or business or for investment if such property is exchanged solely *for property of like kind* which is to be held either for productive *use in a trade or business or for investment.*”
- **Three requirements:**
 - Exchange of properties
 - Properties are like-kind
 - Properties are held for use in a business or for investment
- §1031 is not elective (e.g., sale leaseback; trade in)

Overview

- **Broad application**

- Exchange requirement can be satisfied by sale and purchase transactions
- Value balancing allowed
- Liberal like-kind definition for real property

- **Common uses**

- Tax deferred reinvestment
 - Individual assets or mass assets (e.g., leasing inventory)
- Diversification

Overview

- **Tax consequences**

- **Gain** realized is recognized (taxable) to the extent Taxpayer receives cash or non like-kind property ("boot")
 - Any excess of debt on relinquished property over debt on replacement property (net debt transferred) is treated as boot received, but is offset by boot transferred
 - Net debt assumed does not reduce any boot received; instead, treated as boot paid and offsets realized gain
- **Basis** of replacement property = basis of relinquished property (including boot paid), minus boot received, plus gain recognized.
- **Loss** is not allowed, but is preserved in carryover basis

Overview

- **Tax consequences (con't)**

- **Recapture** (including intangible drilling costs, depletion, and equipment depreciation) is recognized to the extent recapture property is exchanged for non-recapture property
- **Multiple properties** require complicated calculations involving exchange groups and residual groups (1.1031(j)-1)

Overview

- **Illustration of a basic exchange transaction**

Property	Value	Basis	Debt	Net Value
Relinquished Property	100	65	30	70
Replacement Property	90		20	70

- *A's realized* gain = \$35 (\$90 replacement property received, plus \$10 net debt transferred, minus \$65 basis)
- Boot received = \$10 (net debt transferred)
- *A's recognized* gain = \$10 (lesser of \$35 gain realized or \$10 boot received).
- *A's basis* in the replacement property = \$65 (\$65 basis of the relinquished property, less boot of \$10, plus recognized gain of \$10). Deferred gain = \$25 (\$90 value - \$65 basis).

Overview

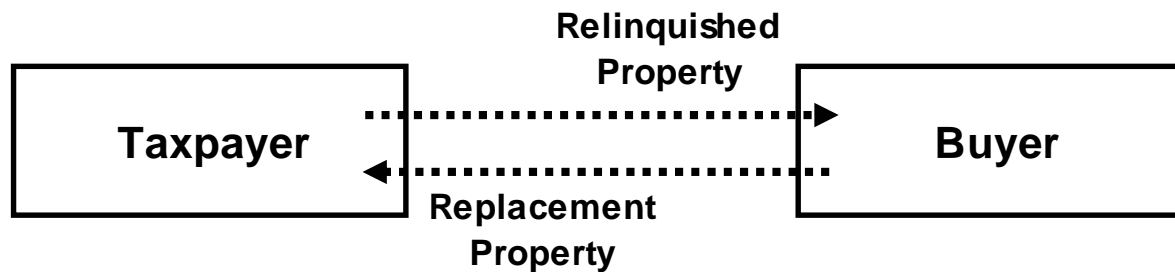
- **Borrowing**

- Against relinquished property before exchange
 - Can reduce boot received (to extent debt assumed would otherwise exceed debt transferred)
 - IRS might characterize loan proceeds as disguised boot (PLR 8434015)
 - Probably OK if business purpose (*Garcia*)
- Against replacement property after exchange
 - Risk that proceeds treated as boot received from Seller; cannot be netted against boot paid
 - Probably OK if not effected or binding prior to receipt of replacement property

Exchange Requirement

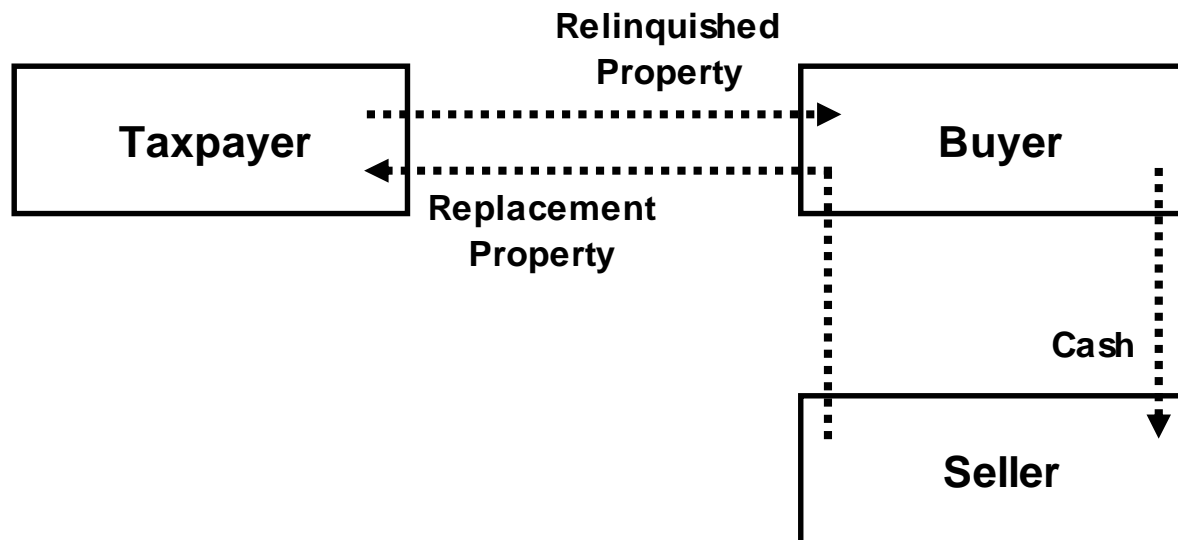
Exchange Requirement

- Direct exchange – two party transaction



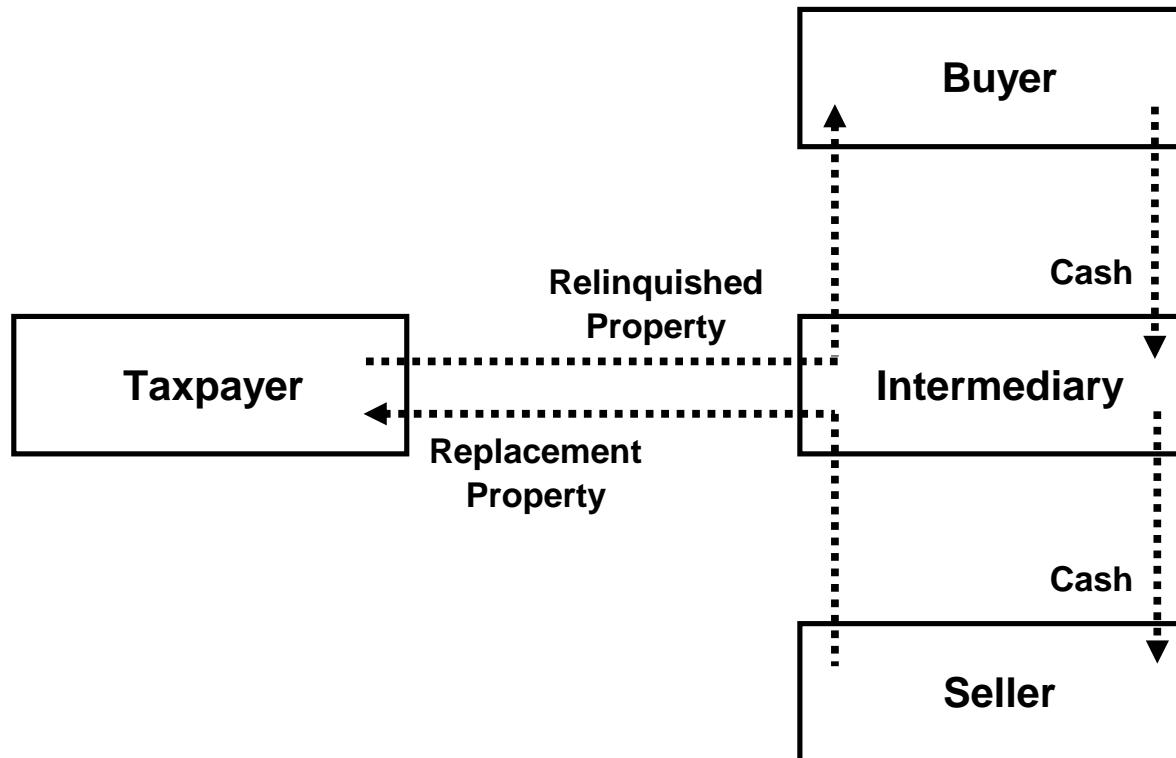
Exchange Requirement

- Indirect exchange – three party transaction



Exchange Requirement

- Intermediary exchange



Exchange Requirement

- **Deferred exchange**

- Deferred exchange = disposition of relinquished property before receipt of replacement property
- **45-day identification period**
 - Taxpayer must identify the replacement property within 45 days after the disposition date
 - Detailed rules for identifying the replacement property, alternative and multiple replacement properties, property to be produced, etc.
- **180-day exchange period**
 - Taxpayer must receive the replacement property by the earlier of (a) 180 days after the disposition date or (b) the due date (including extensions) of the Taxpayer's return for the year of the disposition

Exchange Requirement

- **Constructive receipt issue**
 - If taxpayer is in constructive receipt of proceeds of sale of relinquished property, the sale is fully taxable.
 - Four **safe harbors** in Reg. §1.1031(k)-1(g)
 - Security or guarantee arrangements
 - Qualified escrow accounts and qualified trusts
 - Qualified intermediary ("**QI**")
 - Interest and growth factors
 - Disqualified persons can't serve as QI
 - Employee, accountant, attorney, banker, or broker within two years, or related to taxpayer (10% ownership test)

Exchange Requirement

- **Parking transactions**

- Parking transaction (a/k/a reverse exchange) = acquisition of replacement property before disposition of relinquished property
- Typical structures:
 - *Parked replacement property:* An exchange accommodation titleholder ("**EAT**") acquires the replacement property and holds it until a contract for sale of the relinquished property is executed
 - *Parked relinquished property:* EAT acquires replacement property and immediately exchanges it for Taxpayer's relinquished property, which is held by the EAT until it can be sold

Exchange Requirement

- **Parking transactions (con't)**

- Rev. Proc. 2000-37: IRS won't argue that EAT is acting as Taxpayer's agent if the property is held under a "qualified exchange accommodation arrangement"
 - EAT cannot be a disqualified person
 - Intent to effect a like-kind exchange
 - Written agreement referencing RP 2000-37
 - Relinquished property is identified within 45 days after the date the EAT acquires the replacement property, and the exchange and sale are completed within 180 days of that date
 - *OK for Taxpayer to lease and maintain the parked property, and for Taxpayer to have the economic risk and opportunity for profit on the parked property*

Exchange Requirement

- **Parking transactions (con't)**

- Additional 180-day period for additional (non-parked) replacement properties (CCA 200863024)
- Safe harbor does not apply to replacement property previously owned by Taxpayer within 180 days of its acquisition by the EAT. Rev. Proc. 2004-51.
- Non safe-harbor transactions are not precluded, but EAT must have some real economic ownership of the property to avoid being treated as Taxpayer's agent

Exchange Requirement

- **Build to suit transactions**

- Buyer (or EAT) funds improvements on replacement property
 - Allows Taxpayer to fund improvements using tax deferred proceeds from sale of relinquished property
 - Buyer cannot be Taxpayer's agent (Rev. Rul. 75-291)
 - EAT not viewed as Taxpayer's agent; but limits construction period to 180-days
- Taxpayer should not own the replacement property; might be viewed as exchanging relinquished property for services (*DeCleene*; cf. Rev. Proc. 2004-51)
 - Ownership by affiliate under study by IRS (cf. PLR 200251008)

Exchange Requirement

- **Lease versus exchange**

- Sale of a working interest or lease with a retained overriding royalty interest is a lease (sublease) rather than a sale
- Receipt of like-kind replacement property is treated as a lease bonus rather than a like-kind exchange (*Crooks*)
- Consider a hybrid lease (sale with retained production payment and contingent royalty)
 - Economics are similar to a traditional lease (with a retained royalty), but qualifies as a sale and is eligible for a like-kind exchange

Exchange Requirement

- **Related parties - §1031(f)**

- 2-year holding period for properties exchanged between related parties

- Example: T owns property L with a value of \$100 and basis of \$20. T's corporation (C) owns property H with a value of \$100 and a basis of \$140. T exchanges property L for property H and C immediately sells property L for \$100.

T recognizes gain of \$80 upon C's sale of property L. C's \$40 loss on property H is also recognized, but is disallowed under §267. Disallowed loss offsets any gain subsequently recognized by T on sale of property H.

Exchange Requirement

- **Related parties - §1031(f)**
 - Broad reach: applies to indirect dispositions (sale of entity), indirect exchanges (use of QI), constructive dispositions, and any transaction structured to avoid the purposes of §1031(f)
 - Exception for dispositions where neither the exchange nor the disposition had a principal purpose of tax avoidance

Exchange Requirement

- **Prior ownership of replacement property**

- Example: T owns property L with a value of \$100 and basis of \$20, and property H with a value of \$100 and basis of \$140. T sells property H to Buyer at a \$40 loss. Buyer then exchanges property L for property H. T claims exchange is tax free and basis of property H is \$20.
- Not specifically disallowed, but might be attacked under a variety of theories

Exchange Requirement

- **Installment sale overlap**
 - In a QI deferred exchange that straddles year end, recognized gain is generally reported under the installment method
 - Gain can be further deferred under the installment method to the extent boot consists of a Buyer note
 - Limitations on installment method:
 - Recapture income not deferred
 - Debt > basis
 - Anti-pledging rules
 - Interest charge on large sales

Exchange Requirement

- **Structured installment sale**
 - Exchange agreement with QI specifies that QI will deliver a QI note to the extent of any excess cash
 - QI will fund the note by depositing the excess cash with a financial institution in exchange for the financial institution's agreement to make payments on the note
 - QI retains primary liability on the note
 - Can Taxpayer report QI's note as a buyer deferred payment obligation under the installment method?

Exchange Requirement

- **Failed exchanges**
 - Failure to close on relinquished property
 - Return of relinquished property should have no tax consequences
 - Failure to identify or close on replacement property
 - Results in taxable sale of relinquished property
 - See above regarding installment sale overlap
 - Is a structured installment sale a viable backstop to immediate gain recognition on relinquished property?

Exchange Requirement

- **QI defaults**

- Chose QI wisely
 - Well capitalized QI; segregated accounts; account controls
 - Generally cannot change QIs mid-stream
- Rev. Proc. 2010-14
 - Gain is deferred and recognized under “safe harbor gross profit method”
 - Similar to installment method, but recapture is deferred
 - Loss recognized under §165 principles
 - Imputed interest applies to payments received
- If relinquished debt > basis, consider completing exchange using supplemental funds = debt?

Like-Kind Requirement

Like-Kind Requirement

- **Ineligible properties**
 - Inventory / dealer property
 - Securities
 - Partnership or trust interests (but see below)
 - Choses in action (non-possessory rights to money or property)
- **Like-kind**
 - Generally “same kind or class”
 - Frequent litigation and ambiguous decisions
 - Applied on a property by property basis (1.1031(j)-1)

Like-Kind Requirement

- **General rules**

- Personal property is not like-kind to real property
- U.S. assets are not like-kind to foreign assets
- standard for real property is less restrictive than for personal property
- Goodwill of a business is not like-kind to goodwill of another business

Like-Kind Requirement

- **Mineral interests**

- Economic interest is classified as real property
- Qualifying exchanges
 - Exchange of minerals rights for a city lot and hotel
 - Exchange of producing mineral lease for a ranch
 - Exchange of working interests for royalty interests
 - Exchange of royalty interests for real property
 - Unitization of mineral interests
 - Fee interest exchanged for long-term leasehold interest (but not grant of lease for fee interest)

Like-Kind Requirement

- **Mineral interests (con't)**
 - Production payment classified as a mortgage is not eligible property (chose in action)
 - Working interest subject to a joint operating agreement may be classified a partnership interest (ineligible)
 - Holders can elect out of partnership status (§1.761-2)
 - A valid election out of subchapter K is also respected for §1031 purposes (§1031(a))

Like-Kind Requirement

- **Other oil and gas assets**
 - Equipment
 - Not considered part of real property so exchange of producing well and equipment triggers application of complex multiple properties regulations (1.1031(j)-1)
 - Generally must group equipment relinquished with equipment received according to asset classes or product classes (1.1031(a)-2)
 - Incidental equipment allowed?
 - Geological and geophysical (G&G) data
 - Arguably constitutes like-kind property even where related to different mineral deposits

Like-Kind Requirement

- **Recapture**

- If relinquished property includes natural resource recapture property, receipt of less than equivalent value of natural resource recapture property will trigger recapture income notwithstanding §1031 (§1.1254-2)
- Same rule for §1245 depreciation recapture (§1245(b)(4))

Held for Business or Investment Requirement

Held For Requirement

- **Held for business use or investment**

- Personal use property (e.g., personal residence or ranch) does not qualify; mere hope for sale at a gain ≠ held for investment (Rev. Proc. 2008-16)
- Dealer property does not qualify (held for sale)
- Swap and drop transactions: Do transfers to affiliates/entities shortly after acquisition violate held for requirement?
 - Rev. Rul. 75-292: transfer to a corporation not OK
 - Case law more favorable
 - Same considerations in drop and swap transactions
- Does recent construction on relinquished property qualify?

Partnerships and Disregarded Entities

Partnerships and DEs

- **Property held by a partnership**

- A partnership can effect a like-kind exchange of property
- Rev. Rul. 2003-56: In a deferred exchange, relief of debt on relinquished property is netted against debt assumed on replacement property for purposes of §752, even if transaction straddles year end
- Exchange of contributed property: recognized gain treated first as post-contribution gain, then as pre-contribution gain (PLR 200829023)

Partnerships and DEs

- **Partnership interests**

- General rule: an exchange of partnership interests cannot qualify as a like-kind exchange, even if the partnerships own solely like-kind property
- Acquisition of all of the partnership interests treated as an acquisition of the partnership property (Rev. Rul. 99-6 and PLR 200807005)
- QI's transfer of partnership interests not owned by Taxpayer as replacement property treated as transfer of undivided interest in the partnership property (Rev. Rul. 99-6 and PLR 200909008)

Partnerships and DEs

- **Partnership liquidations and split-ups**

- If some partners want replacement property and other partners want cash or other replacement property:
 - Drop and swap: partnership distributes undivided fractional interests in its property to its partners and they then transfer their interests to a QI; partners can elect to receive cash or qualified replacement property
 - Partial installment sale: partnership effects a like-kind exchange for replacement property plus a QI note, and then distributes note to exiting partners
 - Other variations
- Numerous issues, including held for requirement, constructive partnership, validity of special allocations
- IRS will scrutinize (Form 1065, Sch. B, Lines 13 and 14)

Partnerships and DEs

- **Disregarded entities**

- Exchanges frequently structured as exchanges of 100% ownership interest in an LLC
- 100% owner of an LLC can exchange a partial ownership interest in the LLC for replacement property that is like-kind to the LLC property (Rev. Rul. 99-5)

Partnerships and DEs

- **Undivided fractional interests**
 - Arises in connection with
 - Drop and swap and similar transactions
 - Royalty trusts and other tenant-in-common structures
 - Issue: is the arrangement a tax partnership?
 - Rev. Proc. 2002-22
 - Ruling guidelines for UFI in rental real property
 - 15 factors; difficult to satisfy all
 - Does not apply to co-ownership in mineral property
 - See also §1.761-2 (conditions for electing out of partnership status) (§1031(a))

Summary

Summary

- **Flexible LKE transaction structures allow tax savings with minimal non-tax impacts***
- **Greatest benefit where:**
 - Relinquished property has low basis and debt relative to FMV
 - Replacement property FMV \geq relinquished property FMV
 - Relinquished property debt \leq replacement property debt
- **Tax structuring and documentation ranges from routine to highly complex**
- **Start planning early**

* Assuming a desire or willingness to reinvest sale proceeds in like-kind property.

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