ESTATE OF BARTELL OFFERS TAXPAYER RELIEF IN A REVERSE DEFERRED §1031 EXCHANGE

Authors
Rusudan Shervashidze
Nina Krauthamer

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Over the years, the tax-free like-kind exchange provision of the Internal Revenue Code of 1986, as amended, (the "Code") §1031 has evolved from a direct two-party exchange to deferred exchanges and reverse deferred exchanges. A deferred exchange connotes a sale of property and a later purchase of replacement property. The reverse deferred exchange connotes the acquisition of replacement property followed by a sale of the relinquished property. The latest decision by the U.S. Tax Court (the "Tax Court"), in favor of the taxpayer, offers some guidance to those taxpayers that cannot structure a reverse deferred exchange within the safe harbor provided by the Internal Revenue Service ("I.R.S.").

BACKGROUND

Generally, no gain or loss is 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.[1] Code §1031 was enacted to help taxpayers reinvest or exchange trade or business property without incurring tax at the time of the exchange. If during the transfer the taxpayer received any cash or other property,[2] then the taxpayer recognized gain to the extent of cash or other property received.

Code §1031(3) imposes a timeline during which the transaction must be accomplished. Property received by the taxpayer is not treated as like-kind property if

(i) it is not identified within 45 days; and

(ii) it is not received within the earlier of 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or the due date for the transferor's tax return.[3]

Deferred Exchange

In 1991, the I.R.S. issued regulations that provided rules for a deferred like-kind exchange, where the replacement property[4] is acquired before the relinquished property[5] is transferred. The regulations addressed the following circumstances:

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1 Code §1031(a)(1).

2 *Id.*

3 Code §1031(a)(3).

4 As defined in Treas. Reg. §1.1031(k)1(a).

5 *Id.*

- Security arrangements (such as deed of trust, guarantee, or letter of credit)[6]
- Qualified escrows and qualified trusts[7]
- Qualified intermediaries[8]

Reverse Exchange

Reverse deferred exchanges were not addressed in the regulations, but taxpayers developed a system where the desired replacement property would be "parked" with an accommodation party until the time the taxpayer arranged to transfer the relinquished property to the ultimate transferee in a simultaneous or deferred exchange.

On September 15, 2000, the I.R.S. issued Rev. Proc 2000-37, in response to one taxpayer's attempt to create these complex arrangements. Rev. Proc. 2000-37 provides a safe harbor under which the I.R.S. will not challenge (i) the qualification of property as either replacement property or relinquished property for purposes of Code §1031 and the regulations thereunder, or (ii) the treatment of the exchange accommodation titleholder as the beneficial owner of such property for Federal income tax purposes, if the property is held in a Qualified Exchange Accommodation Arrangement (the "Q.E.A.A.").[9]

For purposes of this revenue procedure, property is held in the Q.E.A.A. if all of the following apply:

- Qualified indicia of ownership of the property is held by the exchange accommodation titleholder (the "E.A.T.").
- At the time the qualified property is transferred to the E.A.T., it is the taxpayer's *bona fide* intent that the property held by the E.A.T. represent either replacement property or relinquished property in an exchange that is intended to qualify for non-recognition of gain (in whole or in part) or loss under Code §1031.
- No later than five business days after the transfer of the qualified property to the E.A.T., the taxpayer and the E.A.T. enter into a Q.E.A.A., which provides that (i) the E.A.T. is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Code §1031 and Rev. Proc. 2000-37, and (ii) the taxpayer and the E.A.T. holder agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. The Q.E.A.A. must specify that the E.A.T. will be treated as the beneficial owner of the property for all Federal income tax purposes. Both parties must report the Federal income tax attributes of the property on their Federal income tax returns in a manner consistent with this agreement.
- No later than 45 days after the transfer of ownership of the replacement property to the E.A.T., the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in Treas. Reg. §1.1031(k)1(c).

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[6] Treas. Reg. §1.1031(k)-1(g)(2).

[7] Treas. Reg. §1.1031(k)-1(g)(3).

[8] Treas. Reg. §1.1031(k)-1(g)(4).

[9] Rev. Proc. 2000-37.

- No later than 180 days after the transfer of ownership of the property to the E.A.T. (i) the property is transferred (either directly or indirectly) through a qualified intermediary to the taxpayer as replacement property, or (ii) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property.

- The combined time period that the relinquished property and the replacement property are held in a Q.E.A.A. does not exceed 180 days.[10]

ESTATE OF *BARTELL V. COMMR.*

Bartell Drug Co. ("Bartell") is a drugstore chain in Seattle, Washington. In 1999, Bartell entered into an agreement to purchase a replacement property ("Lynwood") from a third party in anticipation of structuring an exchange transaction under Code §1031. Bartell later assigned its rights in the purchase agreement to E.P.C., a third-party exchange facilitator, and entered into a second agreement with E.P.C. The second agreement provided that E.P.C. would purchase Lynnwood and Bartell would have a right to acquire it from E.P.C. for a stated period and price. E.P.C. purchased Lynwood on August 1, 2000. Bartell managed the construction on the property and in June 2001, when the construction was complete, Bartell leased the store from E.P.C. until title to Lynnwood was transferred from E.P.C. to Bartell on December 31, 2001.[11]

In late 2001, Bartell contracted to sell its existing property ("Everett"), to a fourth party. Bartell next entered into an exchange agreement with an intermediary, Section 1031 Services, Inc. ("S.S."), and assigned to S.S. its rights under the sale agreement and under the earlier agreement with E.P.C. S.S. sold Everett, applied the proceeds of that sale to the acquisition of Lynnwood, and had the title to Lynnwood transferred to Bartell on December 31, 2001.[12]

This reverse exchange began prior to the issuance of Rev. Proc. 200-37 and, moreover, did not satisfy the terms of the safe harbor. The I.R.S. challenged the tax-free nature of the exchange and argued that under a "benefits and burdens" analysis, Bartell was the actual owner of Lynnwood, and therefore, the transaction would not qualify for Code §1031 gain deferral. The I.R.S. noted that Bartell already owned Lynnwood at the time of the disputed exchange because Bartell (not E.P.C.) had all the benefits and burdens of ownership of the property – namely, 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. Moreover, the I.R.S. contended that Bartell had possession and control over the property during the entire period E.P.C. held the title, first by virtue of the agreement giving Bartell control over the construction of the site improvements and then through a lease that E.P.C. was obligated to provide under the agreement.[13]

The taxpayer pointed out, that both the Tax Court and the Court of Appeals for the Ninth Circuit, to which an appeal in this case would ordinarily go, have expressly

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[10] *Id.*

[11] *Estate of Bartell v. Commr.*, 147 T.C. No. 5 (August 10, 2016).

[12] *Id.*

[13] *Id.*

rejected the proposition that a person who takes title to the replacement property for the purpose of effecting a Code §1031 exchange must assume the benefits and burdens of ownership in that property to satisfy the exchange requirement.

The I.R.S argued that the *Bartell* case was similar to *DeCleene v. Commr.*,[14] where the Tax Court endorsed the benefits and burdens test. The Tax Court pointed out the difference between the *DeCleene* case and the case at hand. In *Decleene*, the taxpayer failed to use a third-party exchange facilitator, acquired the replacement property outright, and held the title directly for more than a year before transferring the title to a buyer. Here, a third-party exchange facilitator was used, and under the case law, there is no specific limit on the period in which a third-party exchange facilitator may hold title to the replacement property before title to the relinquished and replacement properties are transferred in a reverse exchange.[15]

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CONCLUSION

Taxpayers should be advised to structure a reverse exchange to comply with the requirements of the Rev. Proc. 2000-37. The purchase of replacement property in *Estate of Bartell* occurred prior to the issuance of the I.R.S. safe harbor, and that alone may limit the relevance of its holding to other taxpayers. Nevertheless, *Estate of Bartell* may offer some hope to those taxpayers who fail to meet the rigid time requirements of Rev. Proc 2000-37.

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[14] *DeCleene v. Commr.*, 115 T.C. No. 34 (November 17, 2000)

[15] *Estate of Bartell v. Commr.*

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