LIKE-KIND EXCHANGES: THE TAX COURT UPHOLDS A REVERSE DEFERRED EXCHANGE THAT TOOK OVER TWO YEARS

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Like-kind exchanges under section 1031 of the Internal Revenue Code permit a taxpayer to defer the recognition of gain associated with the disposition of property used in a trade or business or held for investment purposes, thereby deferring tax liability associated with the disposition of property. I.R.C. § 1031(a)(1). The rationale for the deferral of taxes is that the taxpayer's economic position remains unchanged: She had funds invested in a particular type of property both before the exchange and afterwards. *See Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260, 268 (1958).

There are a variety of technical rules under section 1031: For example, inventory held for sale won't qualify for like-kind treatment, and neither will securities, such as stocks or bonds. *See* I.R.C. § 1031(a)(2)(A), (B), (C). The Code even provides that a rooster is different than a hen and a stallion is not a mare. *See* I.R.C. § 1031(e) (providing that "livestock of different sexes are not property of a like kind").

In 1991, the Treasury Department issued regulations under Section 1031 to facilitate what are known as deferred forward exchanges that use an intermediary to facilitate an exchange in which the taxpayer receives the new like-kind property *after* transferring the property he wants to exchange. *See* Treas. Reg. § 1.1031(k)-1. The intermediary serves to avoid a situation in which the taxpayer simultaneously holds title to both parties, because a taxpayer cannot conduct a like-kind exchange with himself. These regulations, however, do not apply to a reverse exchange, in which the taxpayer receives the replacement property *before* transferring the property. *See* T.D. 8346, 1991-1 C.B. 150, 150-51 (1991). On August 10th, the Tax Court upheld a reverse exchange in the face of a vigorous challenge by the IRS. *Estate of Bartell v. Comm'r*, 147 T.C. No. 5, 2016 U.S. Tax Ct. LEXIS 21 (Aug. 10, 2016).

Estate of Bartell involved the owners of an S Corporation, Bartell Drug, that operated a chain of drug stores in the area surrounding Seattle. The company entered into a reverse exchange in connection with the acquisition of a new site to replace an existing store. The process began in 1999, when it identified a potential new site; Bartell Drug entered into a formal agreement to purchase this site, known as the Lynnwood property, in May 1999. *Estate of Bartell*, 2016 U.S. Tax Ct. LEXIS 21 at *6-*7. The agreement

provided that the seller would cooperate with Bartell Drug in effectuating a section 1031 exchange and permitted the company to assign its rights under the agreement to an exchange facilitator. *Id.* at *7. Several months later, Bartell Drug entered into discussions with Section 1031 Services, an exchange facilitator; by March 2000, the company and the facilitator had agreed that EPC Two, a special purpose entity, would take title to the Lynnwood property to facilitate an exchange. *Id.* at *8-*9. The entire process was completed on January 3, 2002. *Id.* at *30.

On July 31, 2000, Bartell Drug and EPC Two entered into an agreement for the acquisition of real property and cooperation in effecting an exchange. *Id.* at *14. Under this agreement, Bartell Drug assigned EPC Two its rights under the purchase agreement for the Lynnwood property, and EPC Two agreed to acquire title to the property and to construct specific improvements on it based on specifications set by Bartell Drug. *Id.* at *14-*15. The agreement also provided for EPC Two to lease the property to Bartell Drug when the improvements were complete. *Id.* at *15-*16. EPC Two then acquired the Lynnwood property on August 1, 2000, and construction of a new drug store promptly commenced. *Id.* at *19-*20. Bartell Drug later entered into a lease for the store in July 2001. *Id.* at *24.

Bartell Drug thereafter entered into an agreement to dispose of a store in Everett, Washington, entering into a sale and leaseback arrangement in September 2001 with two parties that had no affiliation with the company. *Id.* at *27-*28. This agreement included a requirement that the buyers cooperate with Bartell Drug in effectuating a section 1031 exchange. *Id.* at *28. Then, in December 2001, Bartell Drug entered into an exchange agreement with Section 1031 Services in which it relinquished the Everett property in exchange for the Lynnwood property. *Id.* at *28-*29. All of the formal transfers were completed between December 28, 2001 and January 3, 2002. *Id.* at *30.

Bartell Drug filed its 2001 information return and included a Form 8824 reporting the exchange involving the Lynwood and Everett properties, indicating that it had relinquished the Everett property on December 28, 2001 and had acquired the Lynwood property on January 2, 2002; the form reflected a deferred gain of $2,804,863. *Id*. at *31-*32. In early 2004, the IRS examined the return and disallowed the deferral of the gain; consequently each of the company's shareholders received a notice of deficiency. *Id*. at *32-*33. The IRS's position was that there was no exchange because Bartell Drug had owned the Lynnwood property prior to the disposition of the Everett property. *Id*. at *35. The taxpayers naturally disagreed.

The Tax Court commenced its analysis by reciting the rationale for section 1031: the fact that there is no meaningful change in the taxpayer's position before and after the exchange. *Id*. at 37. The court also observed that both courts and the government had generally construed section 1031 liberally. *Id*. at *38. Next, the Tax Court traced the evolution of section 1031 from dealing with contemporaneous exchanges between two parties to more complex deferred exchanges that employ an intermediary. *Id.* at *38-39.

In surveying the available administrative guidance, the Tax Court found that no existing regulatory standards covered the case before it:

- The existing regulations, as noted above, only apply to deferred forward exchanges; and
- The guidance applicable to reverse exchanges, Rev. Proc. 2000-37, 2000-2 C.B. 308, only applied to create a safe harbor for reverse exchanges entered into after September 15, 2000.

Estate of Bartell, 2016 U.S. Tax Ct. LEXIS 21 at *41-*43.

In the absence of regulatory guidance, the parties and the Tax Court resorted to case law. In that context, the IRS argued that Bartell Drug already owned the Lynnwood property at the time the formal exchange

occurred because it "had all the benefits and burdens of ownership." *Id.* at *44. The Tax Court rejected this contention, noting that the Ninth Circuit had previously rejected the argument that the titleholder in a section 1031 exchange had to acquire the benefits and burdens of ownership for the exchange to qualify. *Id*. at *45-*46 (citing *Alderson v. Comm'r*, 317 F.2d 790, 795 (9th Cir. 1960)). The court then noted that it had followed *Alderson* in a variety of cases "where the taxpayers used a third-party exchange facilitator to take title to the replacement property to effect an exchange of property in form, who was contractually insulated from any beneficial ownership of the replacement property." *Id*. at *46 (citations omitted). The court explained that in the context of section 1031, "the familiar tax law maxim that the substance of a transaction controls over form" does not apply; instead, the "distinction between an exchange qualifying for section 1031 on the one hand and a sale and reinvestment on the other is largely one of form." *Id*. at *47 (quoting *Barker v. Comm'r*, 74 T.C. 555, 560-61, 565 (1980)).

While the IRS argued that the court had recently applied a benefits and burdens analysis, the Tax Court noted that the case had not involved an intermediary. *Id.* at *52-*54. The Tax Court also observed that it was bound to follow Ninth Circuit authority, as any appeal would be heard by that court. *Id.* at *54 (citing *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971)). Since the Ninth Circuit rejected the benefits and burdens analysis in *Alderson*, the government's argument that it should be applied was unavailing.

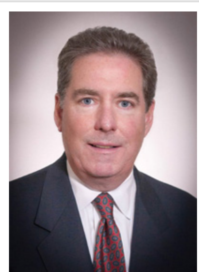
In a similar vein, the Tax Court rejected the government's argument that a reverse exchange should be treated differently than forward exchanges, noting that *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980) had involved a reverse exchange. *Id.* at *64-*65.

Estate of Bartell is a solid win for the taxpayer. It is significant because the Tax Court upheld like-kind treatment in a deferred exchange that took a lengthy period of time. In contrast, the safe harbor for reverse exchanges has tight time limits:

- The relinquished property must be identified within 45 days of the transfer of indicia of ownership for the replacement property to the intermediary; and
- The agreements between the taxpayer and the intermediary contemplate are effective for no more than 185 days from the acquisition of the replacement property by the intermediary.

Rev. Proc. 2000-37, §§ 4.02(4); 4.03(6), 2000-2 C.B. 308, 2000 IRB LEXIS 289, *9, *12.

Estate of Bartell thus provides a helpful reminder that exchanges can be conducted that qualify under the Code, even if they don't qualify under a safe harbor. One *caveat*: Taxpayers and their advisers planning exchanges that fall outside of one of the safe harbors need to remember that a careful analysis of the case law is vital; the result here was driven by the existence of strong Ninth Circuit precedent.



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