

**Office of Chief Counsel
Internal Revenue Service**

memorandum

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date: November 30, 2004

to:

from: _____, Attorney
LMSB,

subject: Taxpayer Corporation Section 1031 Exchange POSTF-151222-04

Taxpayer =
Location AA =
A =
#1 =
B =
C =
D =
E =
F =
G =
H =
I =
J =
K =
L =
M =
N =
O =
P =
Q =
Date 1 =
Name 1 =
Location BB =
\$ A =
Date 2 =
\$ B =
R =

Date 3 =
S =
T =
U =
Location CC =
Date 4 =
V =

W =
Date 5 =
Date 6 =
Date 7 =
\$ C =
\$ D =
Date 8 =
Name 2 =
Location DD =
Date 9 =
X =
Location EE =
Location FF =
Date 10 =
\$ E =
\$ F =
Date 11 =
\$ G =
\$ H =
\$ I =
\$ J =
Date 12 =
\$ K =
Name 3 =
Date 13 =
\$ L =
Date 14 =

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our view. This memo may not be cited as precedent.

This responds to your request for advice on the draft NOPA for the above taxpayer's taxable year ended Date 12 dealing with the issue set forth below.

ISSUE

Whether Taxpayer's sale and acquisition of property qualifies for like-kind exchange treatment under IRC §1031.

CONCLUSION

If Taxpayer was the beneficial owner of the replacement property before the exchange at issue, then the exchange will not qualify for §1031 like-kind non-recognition. Furthermore, if Taxpayer wishes to argue that it was involved in a "reverse exchange", whereby it "parked" the replacement property with an accommodation party, then it will not find relief under Revenue Procedure 2000-37 because the transaction occurred before the Rev. Proc. effective date. Even if the effective date was not an issue and the Rev. Proc. did apply, the transaction would fail under the specific requirements of the Rev. Proc.

FACTUAL SUMMARY

This summary of the facts is based upon the factual statement in the draft NOPA and other information you provided:

Taxpayer owns and operates "#1" "A" in Location AA. Each store has a "C", offers a variety of consumer goods available for sale (from "D" to "E" to "F" to "G"), and provides "H" and "I". The company has one "J" and "K" for all of its "L". The "B" manages the "M" of the company, including "N", an "O", a "P", and three "Q".

On Date 1 Taxpayer entered into a Purchase and Sale Agreement with Name 1 ("Seller") to purchase property located at Location BB, ("Replacement Property") for the amount of \$A. The Agreement provided for Buyer and Seller to cooperate in a Section 1031 exchange, including permitting assignment of the agreement to an exchange facilitator.

On Date 2 Taxpayer guaranteed a Business Loan Agreement in the amount of \$ B on behalf of "R". The loan was scheduled to mature on Date 3. "R", is also known as "S", and is a "T". "U" is a Location CC Corporation and is "Y"'s sole member.

On Date 4 Taxpayer amended the Purchase and Sale Agreement dated Date 1 and assigned its rights under the contract to "R", ("S") and entered into a Real Estate Acquisition and Exchange Cooperation Agreement (REAECA) pursuant to which "S" would acquire the replacement property from the Seller. "S" agreed to construct a "V", lease it to Taxpayer until the Exchange took place, and then sell the property to Taxpayer at "Fair Market Value" to effect the Exchange. For the 24 month period beginning after the date on which "S" acquired the replacement property, "Fair Market Value" would be the acquisition costs incurred by "S". According to "W", "S" acquired the property on Date 5.

"S"'s responsibility for the improvements was solely to disburse funds approved by Taxpayer. Taxpayer retained the right to purchase the Replacement Property at any time from "S" for cash in an amount equal to the "Fair Market Value", as defined in section 3.2.4 of the REAECA: " 'Fair Market Value' of the Replacement Property shall mean the fair market value determined by an appraisal conducted by a nationally recognized real estate appraiser as may be agreed to by Taxpayer and "S" (the 'Appraiser'); provided, however, that if the Replacement Property is purchased from "S" within twenty-four (24) months after the date on which "S" acquired the Replacement Property, then the 'Fair Market Value' shall be deemed to equal its 'Acquisition Cost' as hereinafter defined." Taxpayer was further obligated to pay fees to "S" for its services in connection with the Exchange.

On Date 6 Taxpayer entered into a lease agreement with "S" for a period of 24 months commencing on Date 7 with an option to extend the lease terms. The lease was a "triple net lease", and Taxpayer was responsible for paying for all taxes and insurance costs. Net monthly rent was \$ C per month, with total net rent under the lease not to exceed \$ D. "Net" rent was defined as the amount of rent owing by Tenant after any offsets for any interest owed by Landlord to Tenant related to the premises.

On Date 8 Taxpayer entered into a Purchase and Sale Agreement with Name 2 for the sale of property located at Location DD ("Relinquished Property").

On Date 9 Taxpayer entered into an Exchange Agreement with "X", a Location AA corporation, to serve as a qualified intermediary to the exchange of the Location EE property ("Relinquished Property") for the Location FF property ("Replacement Property").

Taxpayer reported a disposition of a commercial real estate building on Date 10 for a sales price of \$ E and net sales proceeds of \$ F. Taxpayer reported an acquisition of a commercial real estate building on Date 11 for a purchase price of \$ G plus additional purchase costs of \$ H. Payment was made by the escrow funds of \$ F and cash payment of \$ I. Dates and amounts were evidenced by settlement statements. Taxpayer reported on Form 8824, Like-Kind Exchanges, deferred gain of \$ J for tax year ended Date 12.

DISCUSSION

General Principles

I.R.C. § 1031(a)(1) provides that no gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind which is to be held either for productive use in a trade or business or for investment.

When the exchange is not simultaneous, the Code imposes an additional requirement. Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) of the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

The regulations provide further guidance for deferred exchanges. Section 1.1031(k)-1 specifies in detail the circumstances in which deferred exchanges will be accorded nonrecognition treatment. Specifically omitted from such guidance is any application of these regulations to "reverse exchanges." T.D. 8346, 1991-1 C.B. 150, 151 (April 25, 1991).

On September 15, 2000, the Service issued Rev. Proc. 2000-37, 2000- 40 I.R.B. 308, setting forth a safe harbor for reverse like-kind exchanges under § 1031. Under the Rev. Proc. 2000-37 safe harbor provisions, so long as replacement property is properly identified within 45 days and so long as the transaction is completed within 180 days, the Service will not challenge either (a) the qualification of the property as either

replacement or relinquished property (as defined in Treas. Reg. § 1.1031(k)-1(a)) or (b) the treatment of the exchange accommodation titleholder as the beneficial owner if the property is held in a "qualified exchange accommodation arrangement" (QEAA).

Rev. Proc. 2000-37 is effective for QEAA's entered into on or after September 15, 2000. Rev. Proc. 2000-37 provides that "no inference" is intended with respect to the federal income tax treatment of similar arrangements entered into prior to or after its effective date. Further, the Service stated that it recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in the revenue procedure. §3.02 of Rev. Proc. 2000-37.

Rev. Proc. 2000-37 does not apply to Taxpayer's transaction. First, "S"'s acquisition of the replacement property predates the effective date of Rev. Proc. 2000-37. Second, even if Rev. Proc. 2000-37 applied to the transaction, "S" acquired the replacement property more than 180 days before the transfer to Taxpayer. Additionally, there is still some ambiguity as to whether the relinquished property was properly identified in the required 45 day period.

Benefits and Burdens Analysis

If the facts demonstrate that Taxpayer was the beneficial owner of the replacement property, then Section 1031 does not apply, as Taxpayer cannot effectuate a tax deferred exchange with itself. *DeCleene v. Commissioner*, 115 T.C. 457, 469 (2000). The Tax Court generally considers the following factors when determining whether the benefits and burdens of ownership have passed to a purchaser: (1) whether legal title passes;(2) whether the parties treat the transaction as a sale;(3) whether the purchaser acquires an equity interest in the property;(4) whether the sales contract creates an obligation on the part of the seller to execute and deliver a deed and an obligation on the purchaser to make payments;(5) whether the purchaser is vested with the right of possession;(6) whether the purchaser pays income and property taxes;(7) whether the purchaser bears the risk of economic loss or physical damage; and(8) whether the purchaser receives a profit from the operation, retention and sale of the property. See *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, at 1237-38 (1981). These factors are applied to the facts of this case below.

1. *Whether legal title passes.* Here, the relevant documents indicate that legal title passed to "S".

2. *Whether the parties treat the transaction as a sale.* Here, as a result of the REAECA, "S" acquired the right to complete the sale, which presumably it did.

3. *Whether the purchaser acquires an equity interest in the property.* Here, Taxpayer, and not "S" was entitled to the equity in the replacement property for the first twenty-four months beginning with the date of acquisition. If the value of the replacement property went up, Taxpayer was entitled, through the terms of the agreement, to the difference between the acquisition cost and the fair market value of the property for twenty-four months beginning after the day "S" acquired the property. Furthermore, "S" had no risk of loss, since the property was purchased with borrowed funds guaranteed by Taxpayer.

4. *Whether the sales contract obligates the seller to execute and deliver a deed and obligates the purchaser to make payments.* Presumably, in taking legal title, "S" received the deed to replacement property and was obligated to make payments to the seller. In actuality, however, those payments were made from loan proceeds guaranteed by Taxpayer, not "S". Moreover, the REAECA explicitly excused "S" from having to make any payment for replacement property in excess of the funds supplied by the loan proceeds or proceeds from the sale of relinquished property. (See 2.2 of REAECA)

5. *Whether the purchaser is vested with the right of possession.* Here, the terms of the REAECA actually gave Taxpayer the right to lease, and therefore possess, the property. "S" merely possessed the title to the property and never actually had the right to occupy it.

6. *Whether the purchaser pays property taxes after the transaction.* As a result of the triple net lease, Taxpayer, not "S" was obliged to pay property taxes after the transaction.

7. *Whether the purchaser bears the risk of economic loss or physical damage.* Here, "S" had no risk of loss associated with the replacement property. Ultimately, since the note was guaranteed by Taxpayer, "S" had no risk associated with any decline in value or damage to the replacement property. This risk was entirely Taxpayer's. Liability for operating the property also rested with Taxpayer under the terms of the lease.

Taxpayer was responsible for obtaining liability insurance that named "S" as an additional insured party.

Additionally, "S" issued a promissory note to the Taxpayer on Date 13 for \$ L, payable on Date 12. This note was presumably for "S"'s use to pay the interest on the original note between "S" and the bank. Again, this arrangement supports the notion that "S" bore no responsibility or risk for any economic loss or physical damage with respect to the property. Indeed, it appears as though "S" acted merely as a filter, through which these payments on the note were made. Under these circumstances, it appears that Taxpayer, and not "S", was the beneficial owner of the property.

8. *Whether the purchaser receives a profit from the property.* Here, Taxpayer was entitled to the profit from the sale of the property. "S" was not entitled to sell the property under the terms of the REAECA unless Taxpayer gave its consent. Taxpayer, however, was allowed to purchase the property from "S" at the acquisition cost at any time for twenty-four months after the date "S" acquired it. Therefore, if the value of the property went up during this period, Taxpayer, not "S", was entitled to the profits. The only way that "S" could potentially receive any profit from the property would be if the following sequence of events occurred: 1. Taxpayer failed to consummate the exchange, 2. "S" sends an "Exchange Termination Notice" to Taxpayer within 60 days after the expiration of the Contract Period, and 3. Taxpayer does not exercise its purchase option.

An additional issue with respect to the profits interest in the property involves the lease back to the Taxpayer. The terms of the lease provided that Taxpayer would pay \$ C per month for the lease. An appraisal of the fair market rental value conducted by an IRS appraiser shows that a property of the type and size at issue would fairly rent for somewhere between \$ K per month. This extraordinary disparity in the negotiated rent is evidence that "S" never actually received any of the equitable benefit of owning the property. Instead, the rent that "S" received covered the expenses of warehousing the property, not the fair rental value of the property.

In an undated letter received regarding your IDR #12, Name 3, the General Counsel of "U", the sole member of "R", explained that the purpose of the negotiated rent payment was to "compensate Landlord for the risks of ownership of the replacement property." No mention is made of an actual business

purpose or fair rental value of the property. This strongly suggests that "S" had no beneficial ownership interest in the property, since it served as landlord without receiving a profit or even fair market rental value.

Under this analysis, Taxpayer may have been the beneficial owner of the property for federal tax purposes, even though "S" held the legal title. A court will look at all of the facts and circumstances, and consider all of the factors together. Here, the only factors that appear to favor "S" are numbers 1 and 2. The remaining factors suggest that Taxpayer is the true owner of the property.

The only benefit it appears that "S" got was its fee, as described in Section 12 of the REAECA. "S" was not entitled to share any of the gain resulting from the sale of the property, nor was it obligated by any potential loss in value of the property. Therefore, it appears that Taxpayer was entitled to all of the economic benefits and burdens of ownership.

Application of Revenue Procedure 2000-37

Taxpayer is not claiming that the transaction is a reverse-exchange. If, however, Taxpayer wished to try this approach, no relief would be available under the safe harbor of Rev. Proc. 2000-37, because the transaction would have taken place before the effective date of the Rev. Proc. The transaction occurred in Date 14, and the Rev. Proc. is not effective for transactions occurring before September 15, 2000.

Even if, however, the effective date were not an issue, Taxpayer would still fail the requirements of the safe harbor. The Rev. Proc. outlines that the exchange must be completed within 180 days of the transfer of replacement property to the exchange accommodation titleholder. Taxpayer was clearly outside of this time period. Furthermore, the discrepancy with respect to the identification of relinquished property may also disqualify Taxpayer from the safe harbor.

[REDACTED]

[REDACTED]

[Redacted]

1. [Redacted]
2. [Redacted]
3. [Redacted]

[Redacted]

[Redacted]

If I can be of any further assistance, then please do not hesitate to contact me.

Sincerely,

Attorney,