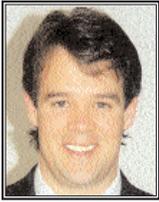


# The Benefits of Like-Kind Exchanges

BY BRYAN S. MACCORMACK



Massachusetts is a national leader in the sharp increase of real estate values in recent years. Many investors would like to cash out to preserve their gain while at the same time avoiding the large tax bills associated with selling.

The use of a LKE has traditionally been an avenue to avoiding, or at least deferring, paying tax on the sale of appreciated real estate. Though adherence to strict timing requirements often limited the availability of a LKE for many taxpayers, evolving rules loosen the timing requirements and now make a LKE attractive to many more real estate owners.

Under Internal Revenue Code §1031 ("§1031"), the gain realized on the sale of property used in a trade or business or property held for investment can be deferred by re-investing the sale's proceeds in "like-kind" property.

The tax liability may even be eliminated if the like-kind property is held until death and the current step-up in basis estate tax rules are retained. This provision applies to individuals, corporations, partnerships, limited liability companies, and Massachusetts Business Trusts.

The rules of §1031 do not require the transfer of properties to occur simultaneously. With a deferred exchange, a taxpayer first sells the relinquished property and one or more like-kind replacement properties must be identified in a written agreement within forty-five (45) days after the closing of the relinquished property.

The replacement property closing must occur on or before the earlier of the due date of the taxpayer's income tax return (including extensions) or 180 days after the transfer of the relinquished property.

In 1991, the preamble to the final regulations issued by the Treasury Department and the Internal Revenue Service stated that the deferred exchange rules do not apply to exchanges where the replacement property is acquired before the relinquished property is transferred ("reverse exchanges").

Since the final regulations were enacted, taxpayers have engaged in so-called "parking" transactions to facilitate reverse exchanges. Under such a trans-

action, a qualified intermediary, as defined in Treas. Reg. §1.1031(k)-1(g)(4), acquires the replacement property and holds it until such time as the taxpayer sells the relinquished property.

Since §1031 or the Treasury Regulations did not sanction these reverse exchanges, taxpayers faced the risk that the IRS would not recognize the transaction as a tax-free exchange.

How could a taxpayer accomplish a qualifying LKE if the owner of the replacement property wants to close before the relinquished property is under contract for sale.

What if a taxpayer receives an offer to purchase his property but is concerned that he may not be able to identify suitable replacement property with the 45-day time limit.

How could a company who needed to expand into larger space purchase new property, make the needed improvements, and sell the existing facility without paying a tax?

The IRS ruling in Revenue Procedure 2000-37 creates a safe harbor for reverse exchange parking transactions if the property is held in a "qualified exchange accommodation arrangement" ("QEAA").

Property will be held in a QEAA if the following six requirements are met: (1) qualified indicia of ownership (legal title to the property) are held by a person ("the exchange accommodation titleholder") who is not the taxpayer or a disqualified person, and either such person is subject to federal income tax or, if such person is a partnership or an S corporation, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. A single member sole purpose limited liability company ("LLC") can be established to acquire and hold legal title to the property.

(2) At the time legal title to the property is transferred to the LLC, it must be the taxpayer's bona fide intent that the property held by the LLC represent either replacement property or relinquished property that is intended to qualify for nonrecognition of gain or loss under §1031.

(3) Within five business days after the transfer of legal title to the LLC, the taxpayer and the LLC enter into a "qualified

exchange accommodation agreement" which provides that the LLC is holding the property for the benefit of the taxpayer in order to facilitate an exchange under §1031 and Revenue Procedure 2000-37 and that the taxpayer and the LLC agree to report the acquisition, holding, and disposition of the property as provided in Revenue Procedure 2000-37. The qualified exchange accommodation agreement must specify that the LLC will be treated as the beneficial owner of the property for all federal income tax purposes.

(4) Within 45 days after the transfer of legal title to the replacement property to the LLC, the relinquished property is identified. See Treas. Reg. 1.1031(k)-1(b)(2).

(5) No later than 180 days after the transfer of legal title to the LLC, the property is transferred as either replacement property or relinquished property.

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA cannot exceed 180 days.

The most common way to structure a reverse exchange is for a parking entity to purchase the replacement property first and

subsequently sell it to the taxpayer.

The taxpayer enters into a contract for the purchase of the replacement property. A single member sole purpose LLC is established to acquire and hold legal title to the replacement property. The taxpayer obtains financing and loans the funds to the LLC for the purchase of the replacement property.

The LLC would execute a nonrecourse promissory note to the taxpayer or the bank, which would be secured by a mortgage on the property. The taxpayer may guarantee some or all of the obligations of the LLC, or indemnify the LLC against costs and expenses.

The taxpayer and the LLC enter into a qualified exchange accommodation agreement, which provides that the LLC is holding the property for the purpose of a §1031 exchange.

The agreement may provide among other things that the taxpayer manage the property or act as a contractor for improvements. The parked property is then leased to the taxpayer under a triple net lease, meaning the taxpayer

would be responsible for the payment of real estate taxes, insurance premiums and repair costs. The amount of any mortgage payment would increase the monthly rent.

Within 45 days after the LLC receives the replacement property, the taxpayer identifies the relinquished property or multiple properties. In the event multiple properties are involved, consideration should be given to establishing a Series of limited liability company interests under Delaware law.

In Massachusetts, the debts, liabilities and obligations of an LLC, whether arising in contract, tort or otherwise, shall be solely the obligation of the LLC. In Delaware, unlike Massachusetts, by utilizing a Series of LLC interests for each property; the debts, liabilities and obligations incurred with respect to a particular Series shall be enforceable against the assets of such Series only, and not against the assets of the LLC generally. 6 Del. Laws 18-215 (2000).

After an offer has been made to purchase the relinquished property, a purchase and sale agreement is executed and the taxpayer assigns its rights under the purchase and sale agreement to a qualified intermediary to acquire and transfer legal title to the relinquished property.

An exchange accommodation titleholder that satisfies the requirements of Treasury Regulations section 1.1031(k)-1(g)(4) may serve as qualified intermediary. The qualified intermediary is utilized because the Treasury Regulations limit the taxpayer's ability to obtain actual or constructive receipt of money or other property. See Treas. Reg. §1.1031(f)(1).

A simultaneous exchange agreement is entered into with the qualified intermediary. At the closing, the taxpayer conveys the relinquished property to the buyer by direct deed.

The Revenue Procedure permits the taxpayer and the LLC the right to enter into an agreement to purchase the parked property at a fixed price. The qualified intermediary uses the sales proceeds from the relinquished property to pay the LLC for the replacement property. The LLC then pays off the promissory note and conveys title to the replacement property to the taxpayer.

An often-overlooked advantage of a LKE is the elimination of taxes if the replacement property is held until death. Now that reverse exchanges are sanctioned under Revenue Procedure 2000-37, there are exceptional planning opportunities and more flexibility for investors in structuring their transactions as tax-free exchanges.

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*Bryan S. MacCormack is an associate with Cushing & Dolan in Boston. He has an LL.M. in taxation from Boston University School of Law and practices in the areas of taxation, corporate transactions and estate planning.*