Landmark Tax Court Decision Approves Non-Safe Harbor Reverse Like-Kind Exchange

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In August, the U.S. Tax Court issued an extremely taxpayer favorable Section 1031 like-kind exchange decision. A like-kind exchange is an effective tax deferral strategy used by business owners and investors to defer taxes that would otherwise be owed on property sold when like-kind replacement property is purposed, usually through the use of an exchange intermediary.

To complete a like-kind exchange, a taxpayer must exchange property it owns for property owned by another party. In the long awaited decision of the *Estate of George H. Bartell, Jr. v. Commissioner*, 147 T.C. 5 (2016), the Tax Court held that replacement property to be acquired as part of a like-kind exchange can be parked with an accommodation party who has no burdens or benefits of ownership, and that the exchange accommodation party can hold legal title to the property for longer than allowed under the established reverse exchange safe harbor. This sage harbor established by the U.S. Treasury Department in Rev. Proc. 2000-37 allows taxpayers to "park" replacement property with an exchange accommodation party for no more than 180 days prior to being transferred to the taxpayer. In this new case, the Tax Court allowed the exchange despite the fact that the accommodation party held title to the property longer than the 180 day safe harbor limit and without the benefits and burdens of ownership. The Tax Court's holding open up the door for like-kind exchange planning opportunities outside of the safe harbor.

In this new case, the taxpayer sold the relinquished property through an exchange intermediary and received replacement property that had been acquired by an accommodation

party in furtherance of the taxpayer's exchange. The accommodation party held the replacement property for over a year before transferring it to the taxpayer pursuant to an agreement between the taxpayer and the accommodation party entered into in anticipation of a like-kind exchange. Although the accommodation party held legal title to the replacement property, the taxpayer funded all acquisition and construction costs, guaranteed the construction financing, and managed the construction of a new building. The agreements the taxpayer entered into with the accommodation party as part of the like-kind exchange prevented the accommodation party from realizing the benefits or suffering the burdens normally associated with owning property, such as property taxes, insurance and other liabilities.

The IRS attempted to apply a "substance vs. form" theory to establish that the taxpayer (and not the accommodation party who held legal title) effectively owned the replacement property because the taxpayer had all the burdens and benefits of ownership. The RIS argued that because the taxpayer, in substance, owned the replacement property, it could not receive it in exchange for the relinquished property the taxpayer sold.

The Tax Court analyzed applicable case law and determined that, in a situation where a like-kind exchange is intended from the beginning of the transaction and a third party exchange accommodation party instead of the taxpayer acquires title to the replacement property to facilitate the exchange, the form of the transaction rather than the substance could control. The Tax Court held that accommodation party need not assume the "burdens and benefits" of ownership of the replacement property to be considered the owner for purposes of Section 1031. While the taxpayer was successful in this recent case, taxpayers may want to consider acquiring replacement property through a taxpayer friendly third party who has burdens and benefits of ownership in order to defeat future IRS arguments.

With proper planning it may also be possible for a party related to the taxpayer to ground lease unimproved land it already owned to a third party accommodation party who builds replacement property improvements on the land. The taxpayer could then acquire the improvements built on the ground leased property as replacement property in the second leg of a deferred like-kind exchange through a deed and assignment of the lease. This lease structure is another powerful technique but is the topic for another day.

Like-kind exchanges are an effective tax planning strategy that can be used by taxpayers to defer tax on the sale of appreciated property, sometimes forever. For example, individual taxpayers can exchange again and again until they die, at which time their basis in the property is stepped up to its fair market value. This case opens up more opportunities for taxpayers considering reverse or construction exchanges when proper planning is implemented on the front end.