

Estate Planning Benefits of Deferred Like-Kind Exchanges of Real Estate

Estate planners are often asked to design strategies for reducing taxes and creating wealth. A deferred like-kind exchange of real estate achieves both objectives. This article examines deferred exchanges and the IRS' new safe harbor.

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The IRS recently issued Rev. Proc. 2000-37,¹ which provides a new safe harbor that may be used to qualify a reverse like-kind exchange of real estate as a tax-deferred exchange under Section 1031. Section 1031 states that neither gain nor loss is recognized when property (the "relinquished property") held for investment or for productive use in a trade or business is exchanged for "like-kind" property (the "replacement property").

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"Like-kind" refers to the nature or character of property, and not to its grade or quality. For example, any type of real estate, whether improved or unimproved, can be exchanged for any other type of real estate, including leaseholds of 30 years or more. If cash or property that is not like-kind ("boot") is received in addition to the replacement property, the gain recognized is limited to the fair market value (FMV) of the boot.

Like-kind property does not include stock in trade or other property primarily held for sale (i.e., inventory). Section 1031 also does not apply to stocks, bonds, notes, evidences of indebtedness, partnership interests, certificates of trust or beneficial interest, and choses in action.

Estate planning benefits of like-kind exchanges

The major benefit of a tax-deferred exchange of real estate is that it is a wealth builder. The process may be repeated over and over without recognizing any gain. Gain is recognized only when the replacement property is sold. If the replacement

property is held until death, gain is never recognized because of the step-up in basis to FMV at the time of death.

Although the value of the real property is included in the estate, payment of the estate tax may be covered by life insurance owned by a third party, such as an irrevocable life insurance trust (ILIT). If the ILIT is properly structured, no part of the death benefit is included in the estate, thereby eliminating the need to liquidate the real estate to pay the tax.

Special-use valuation. Like-kind exchange planning may be especially useful in conjunction with the special-use valuation election under Section 2032A, as shown in Ltr. Rul. 199945066. In that ruling, a husband and wife, through their revocable trusts, owned undivided interests in real property used exclusively for ranching purposes. When the wife died, their son inherited her interest in the ranch. The wife's estate elected special-use valuation (and valued the real property based on its actual use as a ranch rather than

at its highest and best use). Husband and son continued to operate the ranch but maintained separate herds. Father and son decided to divide the ranch between them so that each owned separate tracts instead of owning the whole ranch as tenants in common.

The exchange of interests between father and son raised two issues: Whether the exchange triggered the special-use valuation recapture tax,² and whether the exchange required recognition of gain. The IRS ruled favorably on both issues, concluding that because the ranch continued to be owned by family members as a ranch, the recapture tax was not triggered. Further, because the exchange qualified as a like-kind exchange, no gain was recognized.

Asset protection and like-kind exchanges. For asset protection purposes, an individual or an entity (corporation, partnership, etc.) may take title to the replacement property in the name of a single-owner entity, such as a qualified Subchapter S subsidiary (QSUB) or a limited liability company (LLC). In private letter rulings, the IRS has held that since single-owner QSUBs and LLCs are not treated as separate entities for income tax purposes, the acquisition of the replacement property by either a QSUB or LLC is treated as if received directly by the owner of the QSUB or LLC.³

In addition to asset protection planning, there are other reasons

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for using QSUBs and LLCs to own property. These include (1) lender requirements and (2) the use of separate entities to own "good" and "bad" properties. When good and bad properties are owned by the same entity, the good properties are exposed to the liabilities of the bad properties. For example, property that may be environmentally damaged (or otherwise exposed to extreme liability) and property that may be inadequately insured should not be owned in the same entity that owns property that is not so burdened.

Structuring deferred like-kind exchanges

In a like-kind exchange, one party transfers a property to another party in exchange for a like-kind property. Such simultaneous exchanges are not the norm. Most exchanges are done on a deferred basis since it is not always possible to effect a direct two-way transaction. In a typical deferred exchange, one party sells his/her property, and the proceeds of the sale are held by a qualified intermediary. The intermediary uses the sale proceeds to purchase the replacement property, and delivers title to the taxpayer.

A deferred exchange has strict time constraints. The replacement property is not treated as like-kind if (1) it is not identified as property to be received in the exchange within 45 days after the transfer of the relinquished property, or (2) the replacement property is received after the earlier of (a) 180 days after the date the relinquished property is transferred or (b) the

due date of the taxpayer-transferor's tax return for the year in which the relinquished property is transferred.⁴

Deferred exchange safe harbors. In 1991, the IRS issued final Regulations on deferred exchanges, which contained four deferred exchange safe harbors.⁵ The purpose of the safe harbors is to avoid a situation where the taxpayer would be deemed to be in constructive receipt of the sale proceeds before the replacement property is received. If the taxpayer is in constructive receipt, the exchange does not qualify for deferral of gain under Section 1031.

For example, one popular safe harbor is the use of a qualified intermediary.⁶ Under Reg. 1.1031(k)-1(g)(4), the qualified intermediary is not deemed to be the transferor's agent. Accordingly, the qualified intermediary may receive the sale proceeds and continue to hold those proceeds and use them to acquire the replacement property without fear that the transaction will not qualify as a like-kind exchange.

Reverse-Starker exchange

Unfortunately, the 1991 Regulations do not apply to exchanges in which the replacement property is acquired before the relinquished property is transferred.⁷ This reverse like-kind exchange is also known as a reverse-Starker exchange after the case that resulted in the adoption of the original Section 1031 Regulations.⁸ The new reverse-Starker safe harbor described in Rev. Proc. 2000-37 is designed to cover such situations.

Purpose of reverse like-kind exchange. The purpose of the new "reverse" safe harbor is to cover

¹ 2000-40 IRB 308, WL 1338979.

² See Section 2032A(c).

³ Ltr. Ruls. 9807013 and 199909054.

⁴ Section 1031(a)(3).

⁵ Reg. 1.1031(k)-1(g).

⁶ Reg. 1.1031(k)-1(g)(4).

⁷ TD 8346, 1991-1 CB 150, 151; TAM 200039005.

⁸ Starker, 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979).

those situations where the replacement property or the relinquished property must be "parked" because it is not possible to otherwise comply with the requirements of Section 1031. The following examples illustrate "parking" transactions for which the new safe harbor has been created.

Example 1. John wants to sell his rental property in a tax-deferred exchange. Mary owns a replacement property that she wants to sell for cash immediately. Under the safe harbor, Mary can "park" her property with an "exchange accommodation titleholder" (EAT) in a "qualified exchange accommodation arrangement" (QEAA). John can furnish the funds or guarantee a loan to the EAT to pay Mary. When John finds a buyer for his property, he transfers the property to the EAT in exchange for Mary's property.

Example 2. A variation would be for the EAT to exchange the replacement property for the relinquished property and hold the relinquished property until a buyer is found. The latter procedure would be appropriate if, for example, John needs the replacement property immediately.

In either example, the exchange will qualify under Section 1031 as a tax-deferred exchange. The IRS will not challenge the qualification of property as either replacement or relinquished property or the treatment of the EAT as the beneficial owner of the property for federal income tax purposes in those situations where the property is sold to the QEAA. Consequently, the safe harbor allows the taxpayer to treat the EAT as the owner of the property for tax purposes rather than as the taxpayer's

Like-kind exchange planning may be especially useful in conjunction with the special-use valuation election under Section 2032A.

agent. If the EAT were treated as the taxpayer's agent, the transaction would not qualify under Section 1031.⁹

QEAA requirements

The following is a summary of the QEAA requirements, as set forth in Rev. Proc. 2000-37:

1. Qualified indicia of ownership. The EAT must hold title to the replacement property from the date of acquisition until the property is transferred to complete the transaction. The EAT must be subject to federal income tax or, if treated as a partnership or S corporation for federal income tax purposes, more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax. The EAT cannot be the seller or a disqualified person. Because a qualified intermediary may not be the seller or a disqualified person, then the same person or entity should be able to act in the dual capacity of EAT and qualified intermediary. Generally, a disqualified person is a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within a two-year period.¹⁰
2. At the time the property is transferred to the EAT, it is the taxpayer's bona fide intent that the property held by the EAT represent either

replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under Section 1031.

3. Qualified Exchange Accommodation Agreement. No later than five business days after the transfer to the EAT, the taxpayer and the EAT enter into a written agreement providing that:
 - The EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37.
 - The taxpayer and the EAT agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37.
 - The EAT 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 income tax returns in a manner consistent with the QEAA.
4. No later than 45 days after the transfer of the replacement property to the EAT, the relinquished property must be identified, as provided in Reg. 1.1031(k)-1(c). The taxpayer may also identify alternative and multiple properties.¹¹
5. No later than 180 days after the transfer of the property to the EAT, (a) the property is transferred (either directly or indirectly through a qualified intermediary) to the taxpayer

⁹ Starker, *supra* note 8; TAM 200039005.

¹⁰ Reg. 1.1031(k)-1(k).

¹¹ Reg. 1.1031(k)-1(c)(4).

as replacement property, or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property.

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

Permissible agreements

Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following arrangements:

- An EAT may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary;
- The taxpayer or a disqualified person guarantees some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnifies the EAT against costs and expenses;
- The taxpayer or a disqualified person loans or advances funds to the EAT or guarantees a loan or advance to the EAT;
- The property is leased by the EAT to the taxpayer or a disqualified person;
- The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides

services to the EAT with respect to the property;

- The taxpayer and the EAT enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the EAT; and
- The taxpayer and the EAT enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the EAT's receipt of the property be taken into account upon the EAT's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the EAT.

The new safe harbor of Rev. Proc. 2000-37 is effective for QEAA's entered into on or after 9/15/00. However, reverse exchanges that do not comply with the safe harbor will not be respected by the IRS.

Conclusion

The purpose of a safe harbor is to provide a convenient structure to achieve the desired tax consequence. Although the reverse-Starker safe harbor may seem complicated, practitioners will welcome it, and they should have

little—if any—difficulty in complying with its requirements. The QEAA seems to have been patterned after the widely used qualified intermediary safe harbor. That safe harbor has resulted in the creation of a new deferred exchange industry consisting of entities devoted to fulfilling the requirements of the safe harbor. Those same entities will now expand their operations to include EATs under the new safe harbor.

Estate planners are frequently asked to design strategies for reducing taxes and creating wealth. The deferred exchange achieves both objectives. ■

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