Diving Deeper into Like-Kind Exchanges

William D. Elliott
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Editor's note: This article is a follow-up to "Trading Spaces: Common Mistakes in a Like-Kind Exchange," which was published in the Summer 2022 TG.

Takeaway

Like-kind exchanges are popular, as many people are interested in deferring the tax on sale of property. When real estate is held in an entity, complexities arise when the owners of the entity have divergent views. Several variations on conventional like-kind exchanges can achieve desired tax results.

When multiple individuals own real property—such as when children inherit their parents' estate or when entities like partnerships or limited liability companies (LLCs) hold the asset—problems can emerge when it comes time to sell that property.

If all the partners in the partnership, members in the LLC, or inheriting children agree on a common form of transaction, the complexity is largely removed. The entity itself either sells the real estate and everyone shares in the sales proceeds, or the entity undertakes a like-kind exchange with everyone participating in the tax deferral. Problems arise when interests diverge.

Some of the investing partners or inheriting children may want to cash out of the real estate, while others want to seek a tax deferral such as through a like-kind exchange. Managing a favorable outcome for everyone is challenging. Fortunately, some common transaction structures have been developed that provide a reasonable chance of yielding a predictable tax result.

Drop-and-Swap Structures

The phrases "drop and swap" or "swap and drop" describe popular structures that enable real estate owned by an entity composed of several owners to engineer a like-kind exchange for some and a cash-out sale for others.

In brief, the partnership distributes the real property to the individuals within the entity, removing the entity-level structure and making the individuals joint tenants (the "drop"). Then partners can individually pursue the form of transaction most suitable to their interests. Some owners might sell out for cash, while others may undertake a like-kind exchange (the "swap").

Drop and swap transactions are grounded in the statutory requirements for like-kind exchanges. For there to be a valid like-kind exchange, real property held for qualified use (the relinquished property) is exchanged for other property of a like-kind that is held for a qualified use (the replacement property). Only real property can be exchanged. Interests in the partnership owning the property do not qualify for a like-kind exchange. Thus, the real estate needs to be distributed out of the partnership to the partners.

For an exchange to qualify as a like-kind exchange, the investor must hold both the to-be-relinquished property and the replacement property either for productive use in a trade or business or as an investment. The qualified purposes may overlap (i.e., property held for productive use in a trade or business can be exchanged for investment property and vice versa).

The problem with the drop-and-swap transaction centers around timing. The Internal Revenue Service (IRS) examines transactions that occurred before and after the like-kind exchange. Could the IRS argue that the partners held the relinquished property for the sole purpose of exchanging it? How can the partners prove they are holding the relinquished property for a qualified use?

Fortunately (for taxpayers, at least), the courts have historically rejected such arguments. A leading case, *Bolker v. Comm'r*, 760 F.2d 1039, 1044-45 (9th Cir. 1985), involved a sole shareholder of a corporation that had the corporation liquidate and distribute a certain piece of real property to him as the sole shareholder. On the same day, the shareholder entered a contract to exchange the property for other like-kind real property. The IRS argued the shareholder did not have the qualified intent because he acquired the relinquished property for the purpose of exchanging it. The Ninth Circuit rejected the IRS' claim because the shareholder both owns and holds the property, and as long as the shareholder did not intend to sell the property or use it for personal use, then he held the property for a qualified use. Courts have found the replacement property is essentially a continuation of the relinquished property, but still unliquidated. Thus, investors can enjoy some level of confidence that a like-kind exchange is possible after a drop-and-swap transaction.

The IRS could challenge drop-and-swap transactions on other grounds, such as the individual investors (partners) did not initiate the exchange, but instead the partnership was actually the transaction party. This is a "substance over form" argument. Some facts that might strengthen the IRS' argument include:

- The partnership negotiated the complete transaction.
- The partnership received the offer to purchase the real estate from an unrelated individual.
- The individual partners did not pay any portion of the real estate commission.
- The individual partners did not pay any of the operating expenses between the date of the deed and the date of the sale.
- The partnership accepted the first offer but recast the transaction into a drop-and-swap before closing.

Reverse Exchanges

A reverse exchange involves the investors acquiring the replacement property before the relinquished property is sold. There might be good reason for reversing the order of the transaction. For example, the seller of the replacement might need to sell the property, and locating a buyer of the relinquished property is taking time. The investors may want to be certain they can obtain the essential property before undertaking the large like-kind exchange. They might want to start zoning or financing on the replacement property before the exchange takes place.

The IRS has made reverse exchanges somewhat easy by creating a safe harbor. As long as the investor falls within that safe harbor, tax consequences are predictable. For this to apply, the transaction requires that someone acquires the replacement property before exchanging it with the investor. Under the safe harbor, an exchange accommodation titleholder, or EAT, can acquire the replacement property and hold it until the disposition of the relinquished property. Once a buyer for the relinquished property is found, the EAT transfers the replacement property to the investor. The investor could also acquire the replacement property and have the EAT hold title to it.

The EAT must hold qualified indicia of ownership of the replacement property and continue to do so from the initial acquisition until it's transferred to the investor. Additionally, the investor must have a bona fide intent to exchange the relinquished property for its replacement. Within five days of the replacement property's transfer to the EAT, the investor and the EAT must have a formal agreement dealing with the EAT's ownership of the replacement property. This is commonly called a qualified exchange accommodation agreement, or QEAA.

In a reverse exchange, the relinquished property must be identified within 45 days of transferring the replacement property, and the EAT has 180 days to transfer the replacement property to the investor.

The safe harbor for reverse exchanges, which permits all kinds of contractual or legal relationships, illustrates the IRS' ability to ensure certain results. The following circumstances illustrate some of the more commonly encountered and permissible contractual relationships:

- **Guarantees are permitted.** The investor can guarantee some obligations of the EAT, such as debt or protection against expenses.
- **Debt can be extended.** The investor can loan money to the EAT.
- **Leasing permitted.** The EAT can lease the replacement property to the investor.
- **Management of property.** The investor can contract with the EAT to manage the replacement property or supervise improvements to the property.

In the safe harbor, the IRS is showing a practical side by allowing a variety of circumstances to be used. These permissible circumstances are commonly encountered in the marketplace, so the IRS is trying to permit common financial and business tools while at the same time allowing the parties to accomplish a tax-free reverse exchange.

The IRS has made clear that reverse exchanges can occur outside of the safe harbor, but most real estate investors and their advisors prefer the definite guidance offered by the safe harbor. In cases where the United States Tax Court approved a reverse exchange outside of the safe harbor, the essential issue was whether the third-party accommodation party had the benefits and burdens of ownership.

The use of single-member LLCs to hold title to real property is another development involving reverse exchanges. Single-member LLCs are disregarded for tax purposes. Additionally, newer series LLCs are seen as suitable ownership vehicles for the replacement property.

Tenants in Common Arrangements

Rather than having separate interests, an investor might want to acquire replacement property with others and contemplate acquiring an LLC interest in an entity that owns the property. Unfortunately, since the LLC is not considered real property, the exchanges previously outlined will not apply. The investor must acquire an interest in real property, not an interest in an entity that owns the real property.

In this situation, the usual arrangement is for the investing group to enter into a tenants in common (TIC) arrangement, with each investing person acquiring an undivided interest in the property. TICs are structured to avoid partnership status. Cash distributions must be distributed pro-rata, tax allocations are pro-rata, and carried interests are not permitted.

A variation for co-ownership form is the Delaware Statutory Trust, which is attractive for persons not wanting management responsibility.

Elliott (bill@wdelliottlaw.com) is a Dallas tax attorney, Board Certified, Tax Law; Board Certified, Estate Planning & Probate; Texas Board of Legal Specialization; and Fellow American College of Tax Counsel.