2018

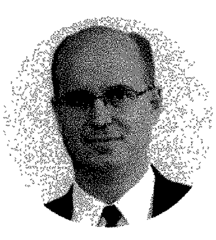
Effect of IRS Nonacquiesence on Tax Planning and Reporting

Bradley T. Borden

Like-Kind Exchange Corner

Effect of IRS Nonacquiesence on Tax Planning and Reporting

By Bradley T. Borden



BRADLEY T. BORDEN is a Professor of Law at Brooklyn Law School.

The IRS lost its challenge of the nonrecognition treatment of a non-safe-harbor Code Sec. 1031 reverse exchange in *Bartell Est.*[1] The IRS had the option of appealing the decision to the Ninth Circuit, but instead it issued an Action on Decision ("AOD") stating that it does not acquiesce to the Tax Court's decision.[2] This column considers what effect, if any, the IRS action should have on taxpayers and their advisors.

Recall that in *Bartell*, the taxpayer entered into an agreement with a facilitator, pursuant to which the facilitator took title to property. The taxpayer intended for that facilitator-held property to be replacement property in a future Code Sec. 1031 exchange. While the facilitator held the property, the taxpayer oversaw construction of a building on it. Seventeen months after the facilitator took title to the property, the taxpayer sold other property and then took title to the facilitator-held property to complete a Code Sec. 1031 exchange. Relying upon a benefits-and-burdens analysis under *Grodt & McKay Realty, Inc.*, the IRS took the position that the taxpayer became the owner of the property when the facilitator took title.[3] The Tax Court rejected that position and, relying on Ninth Circuit precedent (the circuit to which the case would be appealable), adopted a formalistic interpretation of tax ownership for Code Sec. 1031 transactions with facilitators. Based upon that formalistic interpretation, the court held that the facilitator was the tax owner of the property while it held title to the property.

The AOD

The AOD nicely summarizes the IRS's views on this issue and provides an interesting study of IRS legal analysis. First, the IRS takes issue with the Tax Court's reliance upon case law that was decided before the issuances of Reg. §1.1031(k)-1, which contains the qualified-intermediary and other safe harbors for deferred multiple-party exchanges. Those regulations also provide that they do not apply to reverse exchanges.[4] Notably, because those regulations provide safe harbors, they do not attempt to overturn prior law. The IRS correctly states the law provided in *Bartell*: "a third-party exchange facilitator 'need not assume the benefits and burdens of ownership of the replacement property in order to be treated as its owner for section 1031 purposes before the exchange.'"

Second, the IRS recognizes that in Rev. Proc. 2000-37[5] it has taken the same position the Tax Court takes (disregards benefits and burdens to determine the tax owner), but only if the facilitator holds property for no more than 180 days. The IRS recognizes that if the Rev. Proc. 2000-37 safe harbor does not apply then "the proper treatment of any transactions entered into by or between parties, will be made without regard to the provisions of this revenue procedure." The Tax Court in *Bartell* did not indicate that it considered the Rev. Proc. 2000-37 safe harbor to apply in favor of the taxpayer. In fact, the court recognizes that the revenue procedure was published after the *Bartell* taxpayers undertook the transaction. It also quoted language from the revenue procedure that the IRS recognizes that reverse exchanges may be accomplished outside its safe harbor and that the revenue procedure did not intend any inference regarding the federal income tax treatment of such transactions.

The IRS lost its challenge of the nonrecognition treatment of a nonsafe harbor Code Sec. 1031 reverse exchange in Bartell Est.

Third, the IRS cites *D. DeCleene*[6] as authority for its position that the Tax Court decided *Bartell* incorrectly. The Tax Court expended considerable effort to address the IRS's contention that *DeCleene* should apply to the *Bartell* facts. The Tax Court distinguished the two cases. In *DeCleene*, the taxpayer had acquired property and later transferred title to that property to a facilitator that constructed improvements on the property, and the taxpayer then reacquired the now improved property. The Tax Court held that the exchange in *DeCleene* was an exchange with the taxpayer's self. The Tax Court in *Bartell* concluded that the *DeCleene* holding did not apply to a transaction if the facilitator acquired title to property from a third party, as opposed to the taxpayer.

Fourth, the IRS states that it will not follow *Bartell*. It affirms its position that the benefits-and-burdens test should apply to determine who owns property for purposes of Code Sec. 1031 for transactions that do not satisfy the Rev. Proc. 2000-37 requirements. The IRS concludes its AOD with a bewildering statement: "Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property." One should understand that the IRS's purpose in issuing the AOD is to state its belief that the Tax Court did not correctly decide *Bartell*, but this categorical statement of the IRS's understanding of the law is misplaced. The Tax Court's ruling is a precedential statement of the law. The discussion below will address this matter in greater detail.

Finally, the AOD provides in all caps that it "is not to be relied upon or otherwise cited as precedent by taxpayers."

The Effect of the AOD

The IRS's categorical statement in the AOD is neither an accurate description of the law nor legally binding, but its nonacquiesence may have an *in terrorem* effect on some taxpayers and advisors. Taxpayers and their advisors may shy away from structuring transactions that are similar to the *Bartell* exchange, fearing that doing such a transaction could, at a minimum, result in the IRS challenging its treatment as a Code Sec. 1031 exchange. They may also fear that such a challenge would result in costs to oppose the IRS challenge, that the IRS could successfully convince a court to rule contrary to *Bartell*, and that perhaps penalties could be imposed. This discussion first considers how taxpayers who have reported *Bartell*-like transactions as Code Sec. 1031 exchanges might react, if the IRS were to challenge such a position. It then considers how a taxpayer who is contemplating a *Bartell*-like transaction might account for the AOD in deciding whether to pursue it. Finally, it shows that penalties should not be imposed on a taxpayer who structures *Bartell*-like transactions and reports it as a Code Sec. 1031 exchange.

If the IRS challenges a *Bartell*-like transaction that a taxpayer has already entered into, then the taxpayer has *Bartell* to rely upon to defer its tax treatment of the transaction. If the case is being heard by the Tax Court, the taxpayer should take comfort that the court that decided *Bartell* will rule on its case. The Tax Court will most likely rely upon *Bartell* as precedent. If the appeal of the Tax Court decision would be to a court other than Ninth Circuit, the taxpayer may worry that the other circuit would not rely upon the Ninth Circuit cases cited in *Bartell*, but the contrary result is more likely. Circuit courts recognize that decisions of other circuits "do of course have weight as authority with us even when they are not our own decisions."[7] Thus, other circuits are more likely than not to rely upon the Ninth Circuit cases cited in *Bartell*, and a taxpayer should confidently oppose the IRS if the IRS challenges its nonrecognition of treatment of a *Bartell*-like transaction.

A taxpayer in the planning phase of a *Bartell*-like transaction may entertain various alternative courses of actions. One alternative would be to acquire the replacement property outright, understanding that the acquisition would disqualify the property from serving as replacement property. If the taxpayer planned to dispose of relinquished property and did not have other potential replacement property in mind, the acquisition would mean that gain realized on the subsequent disposition of relinquished property probably could not qualify for Code Sec. 1031 nonrecognition.[8] Thus, the cost of an outright acquisition would be the tax paid on gain that might have otherwise been deferred.

The taxpayer may consider other structures that might allow it to transfer the relinquished property as part of a Code Sec. 1031 exchange. For instance, a related party could acquire the taxpayer's relinquished property and hold it until a third party acquires the property. The taxpayer could then use the proceeds from the sale of the property to the related party to acquire the replacement property immediately following the transfer of relinquished property to the related party. Several private letter rulings grant Code Sec. 1031 nonrecognition to such transactions.[9] Such transactions accomplish the same end result achieved through the *Bartell* structure, but the IRS has privately sanctioned the related-party structure.

The related-party structure may not be feasible in all situations. For instance, the relinquished property may be subject to a loan with favorable terms, and transferring it to a related party could place the loan in default, which would allow the lender to call the loan. In such a situation, the taxpayer must weigh whether using the *Bartell*-like structure provides sufficient benefit to offset the threat that the IRS may challenge the taxpayer's Code Sec. 1031 nonrecognition treatment of the transaction.

In considering the threat that the IRS may challenge the treatment, the taxpayer should consider its alternatives and the cost and benefit of each alternative. The first alternative is to avoid the *Bartell*-like transaction and pay tax on the disposition of property. The cost of that alternative is the tax paid.

The other alternative is to adopt the *Bartell*-like transaction. The taxpayer will incur transaction costs to set up the structure, so the potential tax savings will have to be sufficient to offset those costs. The taxpayer could also incur costs to oppose an IRS challenge, if the IRS audits the transaction and raises the matter on audit. The *Bartell* AOD may increase the likelihood that the IRS will raise such a matter on audit, but there is no apparent reason to expect it to increase the likelihood that the IRS will audit a taxpayer solely because it does a *Bartell*-like transaction. For demonstration purposes, assume no penalties would be imposed for treating a *Bartell*-like transaction as a Code Sec. 1031 exchange (which, as discussed below, is a reasonable assumption). If the IRS audited the taxpayer's return and challenged the reporting position, the taxpayer could simply pay the tax at that point and be done with it, and the taxpayer would have to pay no more than the amount of the deferred tax. Thus, the taxpayer can do a cost benefit analysis comparing the cost of structuring a *Bartell*-like transaction and reporting the disposition of property as a Code Sec. 1031 exchange with the cost of reporting it as a taxable transaction and paying the tax currently. Generally, the cost of taking Code Sec. 1031 treatment will be less than the cost of paying the tax, as illustrated by a simple example.

If the IRS challenges a Bartell-like transaction that a taxpayer has already entered into, then the taxpayer has Bartell to rely upon to defer its tax treatment of the transaction.

Assume a taxpayer would defer $200,000 of taxes by structuring a *Bartell*-like transaction and reporting it as a Code Sec. 1031 exchange. If the taxpayer does not take Code Sec. 1031 treatment, it would pay the $200,000 currently. Assume that it will cost $20,000 to structure the *Bartell*-like transaction. The total cost of doing the *Bartell*-like transaction would equal the $20,000 transaction costs plus the expected cost of paying the deferred tax. The expected cost of paying the deferred tax equals the $200,000 deferred tax multiplied by the probability of paying the deferred tax. If the expected cost of the deferred tax is less than $180,000, the cost of doing the *Bartell*-like transaction (sum of $20,000 transaction cost plus the expected cost of the deferred tax) would be less than $200,000. Thus, if the probability of paying the deferred tax is less than 90 percent, the cost of doing the *Bartell*-like transaction will be less than the cost of paying the tax currently. At the time a taxpayer must decide whether to do a *Bartell*-like transaction, the probability of tax being imposed on the transaction will rarely be greater than 90 percent. Consequently, the cost of doing a *Bartell*-like transaction in this hypothetical most likely would be less than paying the tax currently.

For a taxpayer who has already paid the transaction costs and must decide whether to report the transaction as a

Code Sec. 1031 exchange, the cost of taking the reporting position would simply equal the expected cost of paying the tax. The probability of paying the deferred tax will be less than 100 percent—there will always be a chance that the IRS will not audit the return or raise the matter on audit. Thus, the cost of paying the deferred tax if the taxpayer does the *Bartell*-like transaction will always be less than the cost of not doing the transaction and merely paying the tax.

The AOD does not change this type of cost-benefit analysis. The AOD suggests the IRS will challenge the Code Sec. 1031 treatment of any *Bartell*-like transactions that it becomes aware of, but the probability of it becoming aware of such transactions is less than 100 percent, and most likely considerably less than 100 percent. At the time the taxpayer must decide whether to do the *Bartell*-like transaction, the expected cost of paying the tax will always be less than the cost of paying the tax and should be less than the cost of paying the tax and transaction costs to structure the transaction. While taxpayers cannot take the likelihood of audit and the matter being raised on audit into account in determining whether a substantial-understatement penalty will be imposed,[10] the law does not prohibit them from considering those factors when determining the expected cost of a reporting position.[11]

The IRS does not have a legal basis to impose a penalty on a *Bartell*-like transaction because substantial authority supports the application of Code Sec. 1031 nonrecognition to such transactions. The substantial-authority test consists of the weight-of-authority method and the well-reasoned method.[12] The weight-of-authority method requires comparing weight of authority that supports a reporting position to the weight of contrary authority. For *Bartell*-like transactions, the weight of authority supporting the application of Code Sec. 1031 is the Tax Court's *Bartell* decision. That decision is directly on point, so it is strong authority. The negative authority is the AOD.[13] It is also directly on point, but it is not legal precedent, and the arguments in the AOD were rejected by the Tax Court in *Bartell*, so the AOD is not as strong as the Tax Court decision.[14]

In the absence of certain types of authority, a taxpayer may argue a well-reasoned construction of the statute can provide substantial authority.[15] This well-reasoned method favors the taxpayer's position at least as much as it favors the IRS's position in the AOD. The Tax Court relied upon case law that elevates form over substance in Code Sec. 1031 exchanges to hold in favor of the taxpayer. In the AOD, the IRS makes references to its safe harbors in regulations and a revenue procedure, treating those safe harbors as substantive law that overrules earlier case law. That is poor legal reasoning and should be rejected. IRS safe harbors are, by definition, expansive in favor of taxpayers. They indicate the types of transactions that taxpayers may engage in without IRS challenge. Safe harbors provide no guidance beyond their prescribed scopes. Arguing by negative inference that actions outside a safe harbor violate law or that a safe harbor can override legal authority that governs activities that extend beyond the scope a safe harbor is an inappropriate application of the safe harbor.

Taxpayers doing *Bartell*-like transactions can also show that the acquisition of the replacement property and disposition of the relinquished property are part of an integrated transaction. That showing would help taxpayers overcome prior negative authority and would comply with an IRS private ruling requiring granting exchange treatment to an integrated acquisition and disposition of property.[16] Even if the taxpayer is treated as the owner of the property for tax purposes, one could make a compelling argument that the integrated acquisition of replacement property and transfer of relinquished property should be treated as an exchange.[17] It is the integrated-transaction argument that might weigh most strongly against those who believed that a benefits and burdens test should apply to the ownership question.[18] Under the integrated-transaction theory, the transaction could qualify as a Code Sec. 1031 exchange, even if the exchanger is the tax owner of the property. The *Bartell* court might have adopted the integrated-transaction approach explicitly, if the transaction had evidence of integration in the absence of a facilitator taking title to the property. Thus, the well-reasoned argument supports the taxpayer's nonrecognition position.

Both the weight-of-authority and well-reasoned methods favor taxpayers doing *Bartell*-like transactions. Based upon those methods, the position that Code Sec. 1031 applies to *Bartell*-like transactions would, at a minimum, more likely than not, be upheld. Because that level of authority exceeds the substantial-authority threshold,[19] substantial authority supports applying Code Sec. 1031 nonrecognition to *Bartell*-like transactions. Thus, neither the IRS nor courts can impose a substantial-understatement penalty on taxpayers who treat *Bartell*-like transactions as qualifying for Code Sec. 1031 nonrecognition. That being the case, a *Bartell*-like transaction will often cost less than paying tax that a *Bartell*-like structure would defer.

Continued on page 56