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Bartell and the Expansion of Facilitated Exchanges

Bradley T. Borden

Like-Kind Exchange Corner

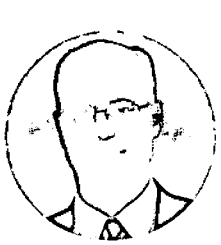
Bartell and the Expansion of Facilitated Exchanges

By Bradley T. Borden

The recent Tax Court decision in *G.H. Bartell, Jr. Est.*[1] appears to build upon courts' longstanding preference for exchanges facilitated by intermediaries. In *Bartell*, the court ruled that a non-safe-harbor reverse title-parking transaction qualified for nonrecognition under Code Sec. 1031, even though the title-parking structure could have shifted the benefits and burdens of ownership to the exchanger while the facilitator held title or the facilitator might have been the exchanger's agent. Although it took about a decade for the court to decide the case, and the Code Sec. 1031 bar had waited with anticipation for its publication, the ruling surprised some observers.[2] This column provides a brief review of the *Bartell* facts and ruling, then speculates about the possible results from an IRS appeal or subsequent cases and discusses how the case might influence opinion writers and affect the future of Code Sec. 1031.

Bartell Facts and Holding

Bartell Drug Co. ("Bartell Drug"), an S corporation, owned several older strip-mall drugstores and felt pressure from competitors to replace existing stores with new stand-alone stores. As part of the process of replacing old pharmacies with new ones, it entered into a contract to purchase land on which it could construct a new store and secured financing to acquire the land and construct a new pharmacy. Recognizing that it would be selling property after acquiring the land and building the new store, Bartell Drug hired a facilitator (a subsidiary of Section 1031 Services, Inc., a highly regarded exchange intermediary company) to acquire and hold title to the acquisition property. Bartell Drug entered into a Real Estate Acquisition and Exchange Cooperation Agreement (REAECA) with the facilitator. The REAECA provided that the facilitator would take title to the property but that Bartell Drug would arrange and guarantee the financing for acquiring the land and constructing the new pharmacy. The facilitator took title to the property on August 1, 2000, just a couple of months before the October 2, 2000, publication of the safe-harbor for title-parking reverse exchanges in Rev. Proc. 2000-37.[3] While the facilitator held title to the property, Bartell Drug entered into construction contracts and secured financing to construct the new pharmacy. After the new pharmacy was completed and ready for occupancy, Bartell Drug entered into a lease with the facilitator on July 11, 2001, and took possession of the property under that lease for fair-market rent.



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

The REAECA provided that Bartell Drug could acquire the land and new pharmacy for an amount equal to the facilitator's acquisition cost from the facilitator at any time within two years after facilitator took title to the property. The acquisition cost was defined to include the amount the facilitator paid for the property plus the cost of construction and any other costs that the facilitator incurred to acquire and hold title to the property. The REAECA provided that if Bartell did not acquire the property within that two-year period, it would have the option to purchase it from the facilitator for fair-market value at the time of purchase. Bartell Drug sold one of its old pharmacies and used the proceeds from that sale to exercise the option and acquire the new pharmacy from the facilitator on December 27 or 28, 2001, for the acquisition cost. The facilitator received a fee equal to 0.5 percent of the acquisition cost. A qualified intermediary affiliated with the title-holding facilitator facilitated the exchange of the old pharmacy for the new pharmacy.

The recent Tax Court decision in G.H. Bartell, Jr. Est. *appears to build upon courts' longstanding preference for exchanges facilitated by intermediaries.*

The question for the Tax Court was whether the transfer of the old pharmacy and acquisition of the new pharmacy qualified for nonrecognition under Code Sec. 1031(a). To qualify for nonrecognition, the transaction had to come within the definition of an exchange and the properties had to be like-kind.[4] To satisfy the like-kind requirement, the facilitator had to be treated as the tax owner of the property while the improvements were being constructed. If Bartell Drug had been the tax owner of the property, the materials and construction activity would have been the consideration, and such items would not be like-kind to the old pharmacy (real property) that Bartell Drug eventually transferred.[5] To satisfy the exchange requirement, the exchanger had to avoid transactions that are the subject of negative authority addressing reverse exchanges. That negative authority generally provides that if a taxpayer acquires property and later transfers other property in nonintegrated transactions, the purchase and sale do not come within the Code Sec. 1031 definition of exchange.[6] Thus, for the transfer of the old pharmacy and the acquisition of the new pharmacy to qualify for Code Sec. 1031 nonrecognition, the court had to find that the facilitator, not Bartell Drug, was the tax owner of the property while the facilitator had legal title to the property or that the transactions were otherwise integrated.[7]

Under general tax principles, the facilitator could be the tax owner only if it held the benefits and burdens of ownership and was not holding the property as Bartell Drug's agent.[8] Ignoring those general tax principles, the Tax Court ruled that while the facilitator had title to the property, the facilitator was the tax owner of the property. Perhaps because it had decided to ignore general tax principles, the Tax Court did not rule on either the agency question or who held the benefits and burdens of the parked property.

After abandoning general tax principles, the Tax Court turned to several Code Sec. 1031 cases for the proposition that courts respect the form of intermediary-facilitated exchanges,[9] and allow exchangers to oversee improvements on property to be acquired.[10] None of those cases was directly on point with the facts in *Bartell* (in fact, one could argue that none of them were more than tangentially related to the facts in *Bartell*). In each of the Code Sec. 1031 cases, however, the court respected the form of the transaction and held that intermediary-facilitated transactions satisfy the exchange requirement. The rationale for each of the holdings appears to be nothing more than Code Sec. 1031 respects the form and ignores the substance of intermediary-facilitated exchanges. Indeed, the *Bartell* court adopted that rationale for its holding:

> [W]here a section 1031 exchange is contemplated from the outset and a third-party exchange facilitator, rather than the taxpayer, takes title to the replacement property before the exchange, the 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.

That holding has three elements: (1) a Code Sec. 1031 exchange is contemplated from the outset; (2) the transaction is facilitated by third-party exchange facilitator; (3) and the facilitator, not the taxpayer, takes title to the replacement property before the exchange. If a transaction satisfies those three elements, according to the Tax Court, neither the benefits-and-burdens test nor agency principles apply to determine who is the tax owner, so the facilitator can be treated as the tax owner without assuming the benefits and burdens of the property for which it holds title and while holding title to property as the exchanger's agent.

The court also observed that the title-parking arrangement in *Bartell* had a finite duration. The court posited that Bartell Drug's facilitator only held title to the property for 17 months and would not have held it more than 24 months. It reached this result by concluding that Bartell Drug would have purchased the property prior to the end of the 24-month period because after that the purchase price would become the property's fair market value. The court's speculation sounds reasonable, assuming the value of the property would continue to increase. The court appears content with its conclusion that the Bartell Drug title-parking arrangement had a finite period and appeared to limit its ruling to title-parking arrangements with finite periods.

Scope of *Bartell*

The transaction in *Bartell* was a title-parking exchange-last reverse improvements exchange. That means that the facilitator took title to replacement property and held it while the exchanger oversaw improvements on the property. Then, after the exchanger was ready to transfer the relinquished property, it acquired the parked replacement property in exchange for the relinquished property. Technically, the ruling only applies to such an exchange. Consequently, it is not directly on point to other types of title-parking transactions. Nonetheless, it would appear to apply to other types of title-parking exchange-last transactions, such as those that do not include improvements.

The decision does not provide direct authority for title-parking exchange-first transactions. Such transactions occur when an exchanger transfers relinquished property to a facilitator in exchange for replacement property, and the facilitator holds that relinquished property until the exchanger can find a buyer for it. Such a transaction could satisfy only two of the *Bartell* elements: (1) an exchange is contemplated from the outset, and (2) the exchange is facilitated by a third-party facilitator. It could not, however, satisfy the requirement that the facilitator hold the replacement property, so *Bartell* would not apply directly to such a transaction.

An exchange-last Rev. Proc. 2000-37 compliant title-parking transaction that is not completed within the required 180-day period would exceed the permitted holding periods in the revenue procedure, so it would not satisfy the safe harbor. Such transactions can nonetheless satisfy the three *Bartell* elements. They could also have a finite duration, but the exchanger would have to amend the exchange accommodation agreement to extend the option periods (which would have been set at 180 days in a compliant transaction). The combination of the originally proposed compliant structure and subsequent extension of the holding period should be able to comply with the *Bartell* elements.

The court emphasized the finite holding period, but it did not express an opinion about whether its holding would apply to title-parking arrangements that have indefinite duration, so that is an open question. If the ruling does apply to only title-parking arrangements that have finite holding periods, the question is whether the holding periods have an outer limit. Undoubtedly, some observers will claim that the 24-month period in *Bartell* establishes something akin to a safe harbor and will advise clients who wish to rely upon the ruling that their arrangement must not extend beyond that 24-month period. Of course, if the title-parking arrangement provides for an escalating option price after an initial 24-month period, the arrangement appears to have a finite holding period under the *Bartell* reasoning. Any title-parking arrangement that extends the potential title-parking period beyond 24 months unfortunately would not fit squarely within the facts of *Bartell*, so a question would exist regarding the applicability of the decision to such an arrangement.

Possible Outcomes on Appeal

The Tax Court ruled that the benefits-and-burdens test does not apply to intermediary-facilitated exchange-last title-parking reverse exchanges. It recognized that this case would be appealable to the Ninth Circuit under the *Golsen* rule and specifically cited *Alderson* as a Ninth Circuit case that did not require the facilitator to hold the benefits and burdens.[11] The Tax Court was aware that the case might be appealed and was careful to consider case law from the Ninth Circuit. If the government appeals the Tax Court's decision, the appeals court could, of course, uphold the Tax Court's decision that the benefits-and-burdens test does not apply—or it could hold that the benefits-and-burdens test does apply. If it does hold that the benefits-and-burdens test applies, it would, at a minimum, overturn the Tax Court. The question then would be whether it could rule on whether the facilitator had the benefits and burdens. Anticipating the circuit court's ruling on that question is a bit complicated.

Appellate courts review questions of law *de novo* and findings of fact for clear error.[12] Those standards of review have an interesting application in the *Bartell* context.[13] The question of who is the tax owner of property is a question of law,[14] so the appellate court could review that question *de novo*. The court could therefore rule whether the benefits-and-burdens test applies to an intermediary-facilitated

exchange. The question of who holds the benefits and burdens related to a property is a question of fact.[15] The Tax Court did not reach a conclusion regarding who had the benefits and burdens of the property while the facilitator held title, so the appellate court would appear to have no factual finding to review for clear error. If it were to rule that the benefits-and-burden test applies, apparently it would have to remand the case to the Tax Court to rule on that fact question. Tax advisors and their clients might consider how likely the government is to appeal the Tax Court's decision (as of the date this column went to press, the government had not indicated how it would respond to the case) and what the decision might be if the government does appeal. In the interim, many tax advisors may be called upon to provide opinions with respect to the tax treatment of similar transactions. The possibility of appeal should not affect the current state of the authority available to opinion writers.[16]

Effect on Opinion-Writing

This decision raises questions for opinion writers. This is the only case on non-safe-harbor title-parking reverse improvements exchanges, and it is favorable to taxpayers. Until this case is overturned on appeal or an opinion on a different matter with similar facts is published, opinion writers must consider how to weigh the decision against other authority. Opinion writers may be tempted to weigh *Bartell* against cases that support finding that Bartell Drug had the benefits and burdens from the date that the facilitator took title. That comparison would, however, appear to be misguided. The question that *Bartell* raises is whether a formalistic standard applies to title-parking reverse exchanges, not if Bartell Drug had the benefits and burdens of the parked property. If *Bartell* is correct, the myriad cases that may support a finding that Bartell Drug held the benefits and burdens would not apply. Opinion writers arguably should consider whether the authority requires considering the substance of a Code Sec. 1031 transaction under general tax principles.

Such a search would return the *DeCleene* case, but the *Bartell* court distinguished the *Bartell* transaction from the *DeCleene* transaction on two grounds. First, the parked property in *Bartell* was property that was not previously owned by Bartell, contrary to the facts in *DeCleene*. Second, Bartell employed a facilitator to take title to the property, DeCleene did not. Thus, in non-safe-harbor title-parking reverse exchanges (which require a facilitator), *Bartell* appears to be the only authority directly on point. As the *Bartell* court pointed out, a significant body of law supports the courts focus on formalism. The benefits-and-burdens rulings would appear to have little weight against *Bartell* because they would not influence the court's decision to apply formalism to Code Sec. 1031 intermediary-facilitated transactions. Thus, *Bartell* appears to be strong authority for granting Code Sec. 1031 nonrecognition to such transactions, with no real negative authority directly on point.

Opinion writers may be concerned that the IRS will appeal the decision and the appeals court will overrule it and hold that formalism does not apply. Some of the cases the Tax Court cited are Ninth Circuit cases, and the Ninth Circuit has been generous to taxpayers in ruling with respect to Code Sec. 1031. That history in the Ninth Circuit suggests that a government victory on appeal is far from certain. Certainly, the government would also consider the likelihood of a successful appeal when it decides whether it should appeal the decision. The possibility that the government will fail also makes that decision less than certain. That uncertainty, coupled with the state of the law prior to a decision by the appellate court, should not affect an opinion writer's understanding of the law as it exists following the *Bartell* decision.

Conclusion

Some observers will recognize *Bartell* as a gift, which does not warrant additional scrutiny. Other observers may be concerned that the decision is too good, and it could provide fodder for two camps that take different views of Code Sec. 1031: one camp might believe that Code Sec. 1031 leaks too much tax revenue and *Bartell* only exacerbates that problem, and another camp might believe that *Bartell* illustrates that Code Sec. 1031 is too formalistic. The first camp might be concerned that the continued expansive interpretation of Code Sec. 1031 jeopardizes a provision that is often slated for the chopping block in tax reform proposals. The second camp would argue that if the exchanger is the tax owner in substance of parked property, lawmakers should take the next step and allow pure reverse exchanges. Treating the facilitator as the tax owner of property when it does not have the benefits and burdens of ownership is economically equivalent to a pure reverse exchange. Such transactions do not have any direct authority allowing them, but they have theoretical support.[17] Perhaps, the law should explicitly allow them. *Bartell* appears to answer some questions, but it could also raise some questions about the future of Code Sec. 1031.

Bartell is now a piece of history and a piece of the law; its future and its effect on future developments are uncertain. Prediction models are invariably prone to error, so,

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until some future action is taken that would change the law, *Bartell* should trump any speculation and take its place as the current law on the type of title-parking reverse exchange that the *Bartell* court considered. Moreover, everyone should pay close attention to the direction Code Sec. 1031 is moving.

ENDNOTES

1 *G.H. Bartell, Jr. Est.*, 147 TC No. 5, Dec. 60,669 (2016).

2 *See, e.g.*, Bradley T. Borden, Tax-Free Like-Kind Exchanges ¶ 5.3[2] (2015) ("Two possible tests would apply in determining whether the exchanger or the accommodation titleholder is the beneficial owner of property: the benefits and burdens test and the agency test.").

3 Rev. Proc. 2000-37, 2000-2 CB 308.

4 *See* Code Sec. 1031(a)(1) (requiring that exchange properties also be business-use or investment property, a requirement that was not at issue in the case).

5 *See Bloomington Coca-Cola Bottling Co.*, CA-7, 51-1 ustc ¶9320, 189 F2d 14; *D. DeCleene*, 115 TC 457, Dec. 54,128 (2000).

6 *See, e.g., G.S. Bezdjian*, CA-9, 88-1 ustc ¶9306, 845 F2d 217; *Dibsy*, 70 TCM 748, Dec. 50,898(M), TC Memo. 1995-447; *E.C. Lee*, 51 TCM 1438, Dec. 43,180(M), TC Memo. 1986-294, *all cited in* footnote 17 of *Bartell*.

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10 *See J.H. Baird Publishing Co.*, 39 TC 608, Dec. 25,816 (1962); *124 Front Street, Inc.*, 65 TC 6, Dec. 33,448 (1975).

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13 *See* CCA 200237020 (June 10, 2002) ("The general characterization of a transaction for federal income tax purposes is a question of law. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n. 16 (1978). The economic substance of a transaction rather than its form controls for federal income tax purposes. *See Gregory v. Helvering*, 293 U.S. 465 (1935). The fact that the documents contain labels that the transaction is, or is not, a sale is not determinative of the actual character. The issue of ownership is governed by the substance of the agreement, not labels used in the agreement. *See Tomerlin Trust v. Comm'r*, 87 T.C. 876 (1986).

The term "sale" is given its ordinary meaning for federal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money. *Comm'r v. Brown*, 380 U.S. 563, 570-71 (1965). The key to deciding whether a transaction is a sale is to determine whether the benefits and burdens of ownership have passed to the purported purchaser. This is a question of fact which must be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attendant facts and circumstances. *Larsen v. Commissioner*, 89 T.C. 1229, 1267 (1987); *Torres v. Comm'r*, 88 T.C. 702, 720 (1987) (citing *Grodt & McKay Realty Inc. v. Comm'r*, 77 T.C. 1221, 1237 (1981); and *Haggard v. Comm'r*, 24 T.C. 1124, 1129 (1955), *aff'd*, 241 F.2d 288 (9th Cir. 1956)).

14 *See Frank Lyon Co.*, SCt, 78-1 ustc ¶9370, 435 US 561, 581, n.16, 98 SCt 1291 (citing *American Realty Trust*, CA-4, 74-2 ustc ¶9528, 498 F2d 1194, 1998) ("The general characterization of a transaction for tax purposes is a question of law subject to review. The particular facts from which the characterization is to be made are not so subject.").

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16 *See* Reg. §1.6662-4(d)(3)(iv)(C) (providing that substantial authority for a position is determined based upon existing authority at the time a return is filed or the end of the tax year to which the return relates).

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1 Steve Frost, *Things You Thought You Knew About Delaware Law, but Maybe Don't ... Recent Delaware Partnership and LLC Case Law*, J. Passthrough Entities, May–June 2013, at 25.

2 *Obeid v. Hogan et al.*, C.A. No. 11900-VCL (Del. Ch. June 10, 2016).

3 *Zimmerman v. Crothall et al.*, 2013 Del. Ch. Lexis 34 (Del. Ch. Jan. 31, 2013).

4 Frost, *supra* note 1.

5 6 Del. C. §18-1101(b).

6 *Obeid* at 11–12. In footnote 5 of the decision, the court cites to various sources in support of this position in the context of corporate management structures.

7 *Id.*, at 13.

8 *Id.*, at 14.

9 *Id.*, at 15.

10 430 A2d 779 (Del. 1981).

11 *Id.*, at 23, citing the *Zapata* decision.

12 *Id.*, at 25.

13 *Id.*, at 30.

14 *Id.*, at 34.

15 *Id.*, at 35.

16 *Id.*, at 36–37.

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transaction where the actions of the party were performed to create a better tax result for the shareholders or the corporation during the period between the date of request for the early re-election and the date of termination of the S corporation election. For example, in Rev. Rul. 78-332, the IRS stated that there was no "pre-arrangement" between A and B with regard to the sale of stock of the corporation from A to B and then the quick resale of the stock from B back to A, perhaps indicating that a showing of a pre-arrangement might have caused a denial of permission to

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until some future action is taken that would change the law, *Bartell* should trump any speculation and take its place as the current law on the type of title-parking reverse exchange that the *Bartell* court considered. Moreover, everyone should pay close attention to the direction Code Sec. 1031 is moving.

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transaction where the actions of the party were performed to create a better tax result for the shareholders or the corporation during the period between the date of request for the early re-election and the date of termination of the S corporation election. For example, in Rev. Rul. 78-332, the IRS stated that there was no "pre-arrangement" between A and B with regard to the sale of stock of the corporation from A to B and then the quick resale of the stock from B back to A, perhaps indicating that a showing of a pre-arrangement might have caused a denial of permission to