9-2020

Twenty Things Real Estate Attorneys Can Do to Not Mess up a Section 1031 Exchange (Part 2: Items 11-20)

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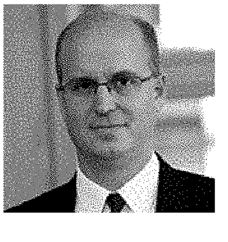
TWENTY THINGS REAL ESTATE ATTORNEYS CAN DO TO NOT MESS UP A SECTION 1031 EXCHANGE (PART 2: ITEMS 11–20)



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Part 1 of this article focused on the issues that arise as property owners begin contemplating an exchange, matters to consider when selecting a QI, and events to plan for as an exchange gets started and the end of the 45-day identification period approaches.[1] This Part II of the article considers complex transactions and matters that real estate attorneys should keep in mind as they work with their clients to ensure exchanges progress smoothly and wrap up according to the exchangers' desired tax goals.

Since the manuscript for Part I was submitted, much has happened in the section 1031 space. Adjustments related to COVID-19 have stalled many section 1031 exchanges. The IRS provided guidance that extends 45-day identification periods and 180-day exchange periods that would otherwise expire between April 1 and July 15. That guidance brought relief to some exchangers, but the industry generally hoped that the IRS would have done more.[2] As of the writing of this article, the IRS has yet to issue additional guidance, but it indicated that it would.[3] That guidance, if sufficiently generous, will help exchangers better navigate the economic fallout of the pandemic. Many exchanges that stalled will eventually move forward (sooner with the help of generous IRS guidance), and, as the exchange industry returns to capacity, the items discussed in this article will be important to remember. Having covered items 1 through 10 in Part I, this Part II of the article picks up with item 11.

11. Don't drop the ball on a drop-and-swap

Drop-and-swaps have become commonplace, and many real estate attorneys see several of these types of transactions each year. A drop-and-swap is a series of transactions that often starts when a tax partnership (i.e., a partnership or LLC taxed as a partnership) receives an offer to purchase its property and the members disagree about how to reinvest the proceeds. Some members of the tax partnership might prefer to reinvest the proceeds in like-kind property as part of a section 1031 exchange; others might wish to do their own exchange, and others might wish to take cash and forgo other investments in real estate. To accommodate all parties, the tax partnership can consider liquidating by distributing tenancy-in-common (TIC) interests to each of the members. The members could then do as they please with their respective TIC interests.

Even though drop-and-swaps are easy to explain, they are complex transactions and have a few potential tax traps. When advising a client with respect to a drop-and-swap, remember that the property must be held as a TIC for tax purposes following the distribution. The advisor must understand the difference between a TIC and a partnership under tax law. For the members of a tax partnership to be treated as TIC co-owners, the partnership must distribute tax ownership of the TIC interests to the members, i.e., the members must acquire the benefits and burdens of the TIC interests.

If the partnership negotiates, the sale enters into the purchase agreement, and takes all of the actions necessary to sell the property, the IRS and courts could treat the partnership as holding the benefits and burdens and as owning the property at the time of the sale. If the partnership owns and sells the property, then it must complete the section 1031 exchange by acquiring the replacement property. Ensuring that tax ownership passes from a tax partnership to the member or members and that the post-distribution arrangement is a TIC, requires prior proper planning. Thus, it is best to get the wheels of a drop-and-swap turning well before the sale occurs.

12. Know what a TIC is and isn't

Having heard about drop-and-swaps, some real estate lawyers may believe that they can accomplish a good drop-and-swap by simply deeding the property from the partnership to the members as TICs right before closing. Unfortunately, tax law might not treat the ownership arrangement of a last-minute distribution followed immediately by a sale as a TIC. Experts in partnership classification believe that for an arrangement to be a valid TIC, it must have a few fundamental TIC characteristics. First, the members must generally have rights to partition the property and sell their TIC interests. Second, any blanket liens on the property should be borne by the members in proportion to their ownership interests. Third, revenue and expenses should be shared by the owners in proportion to their ownership interests. Fourth, the members should share in the management and decision-making related to the property. To comply with these requirements, co-owners of TIC arrangements typically adopt a TIC agreement and a management agreement.

Distributing TIC interests immediately prior to the sale of property raises questions about the status of the interest owned and transferred. If the property is held by the members for only an instant, the members may have difficulty establishing that the transitory arrangement was a TIC. For instance, they might not be able to show that they shared revenue and expenses according to their ownership interests, that they had rights to partition, that they had management rights, that they shared the blanket liens in proportion to their ownership interests, and that they satisfy the other criteria of a TIC for the brief instant between the distribution and the transfer. A properly structured drop-and-swap ensures that the property is distributed and held as a TIC before it is transferred to the buyer.

On the buyer side, exchangers often look to purchase TIC interests as replacement property. They may intend to hold those interests passively, or they may wish to participate in the management of the acquired property. For instance, a developer may wish to be part of a venture to acquire and develop land. The developer may prefer to acquire its interest in the property as part of section 1031 exchange. The developer cannot acquire a joint venture interest (i.e., an interest in a partnership or LLC) as part of an exchange, but it could acquire a TIC interest in the property to be developed. After establishing tax ownership of a TIC interest, the developer might consider contributing the property to a joint venture. From a tax planning standpoint, the developer is probably better off exchanging into a single TIC that will be folded into a joint venture (i.e., a quick TIC) than exchanging into a complex TIC that will develop property. A TIC that develops property often will be so complex that it could start to look like a tax partnership. Based upon Magneson v. Commissioner and its progeny,[4] the quick TIC can have TIC tax attributes and then fold into the joint venture without negating the section 1031 exchange. With quick TICs, be certain the exchanger is the tax owner of the TIC interest and ensure that the stop transaction doctrine does not disregard that step.

Closely held TICs have become very prevalent. Sponsors of real estate funds and joint ventures want to use equity and management structures for such TICs that they use in their joint ventures, complete with profit-sharing and promotes. Some TIC arrangements have TIC agreements and management agreements that appear to comply with Rev. Proc. 2002-22 also include side letters that may introduce profit-sharing or management features that deviate from the guidelines in Rev. Proc. 2002-22. If the arrangements in the side letters would disrupt the TIC classification if they were in the TIC agreement or management agreement, they will likely disrupt the classification from outside those agreements. Because distinguishing between a tax partnership and a TIC is so difficult in many situations, one would not expect to see tax authorities aggressively challenge arrangements that do not perfectly comply with the Rev. Proc. 2002-22 conditions. Nonetheless, egregious deviations may attract the attention of taxing authorities, so don't deviate too far from the guidelines. Profit sharing that is not in proportion to ownership interests may be a deviation that strays too far from the guidelines, and it is easy for tax authorities to recognize and challenge. Some observers believe that arrangements within the entity structures of TIC owners might be a better way to deal with profit sharing and promotes. For instance, a manager may become a member of an LLC investor that is buying a TIC interest and get a profits interest for managing that entity or providing management services to it, instead of receiving a profits interest through the TIC management agreement. If the law respects every entity in the structure, then arrangements in the upper-tier entities or TIC should not disrupt the TIC classification. Issues related to side letters and agreements with structures are still being explored and fleshed out. Industry practices should normalize relatively quickly as demand for such structures grows. In the meantime, be careful to ensure that your arrangement does not become an example of how not to structure a TIC.

13. Know that an S corporation is not a tax partnership

Partnerships and S corporations are both pass-through entities, so they do not pay an entity-level tax. Instead, the income of both types of entities flows through to the members who pay tax on their respective shares of it. Despite that similarity, partnerships and S corporations are different in significant ways that are relevant in the section 1031 context. For instance, S corporations typically recognize gain when they distribute appreciated property to their members, and they must allocate recognized gain pro rata to the shareholders based upon the shareholders' ownership interests in the S corporation. Therefore, S corporations cannot do drop-and-swaps in the same way that partnerships can. If an S corporation simply distributes appreciated property to the shareholders, the corporation recognizes gain, allocates the gain to the members in proportion to their interests in the S corporation, and the members take a fair market value basis in the distributed property. After that gain recognition, the members would have no reason to do exchanges. If only one member wanted to cash out, the S corporation would recognize gain if it were to distribute an undivided interest to the cash-out member or receive cash boot on the sale of property as part of a section 1031 exchange, and it would have to allocate that gain pro rata to the members.

Shareholders do not, however, have to abandon all hope of dividing S corporations tax-free in proximity to doing an exchange. S corporations are subject to the general corporate tax rules, which allow for tax-free divisions. To obtain tax-free treatment on a division of a corporation, the division must have a non-tax business purpose, the pre-division corporation must have an active trade or business, the shareholders must retain their proprietary interests in at least one of the corporations that results from the division, and the business of the divided corporation must continue after the division.[5] These rules limit the types of S corporations that are eligible for tax-free divisions and may restrict the timing of such divisions. An S corporation may have difficulty satisfying the business purpose requirement if it distributes TIC interests to the members as part of the division. Often, the most obvious business purpose for doing a division is a management dispute and disagreement regarding the use and disposition of the corporation's property. If an S corporation has multiple members and multiple properties and divides the management of the properties among the members, a purpose for dividing may be to grant specific members greater management latitude with respect to specific properties. A fundamental attribute of a TIC is that the TIC owners participate in the management of the TIC property, so a division resulting in multiple corporations owning TIC interests probably would have to have a business purpose other than management differences.

An S corporation with multiple properties probably could do a tax-free division by distributing a property out to one of the shareholders. Following such a division, the new corporation and the dividing corporation would both hold at least one property. Each corporation should then be able to do a section 1031 exchange without disrupting the tax-free division. The division could, however, lose its tax-free status if either resulting corporation started but failed to complete an exchange. An S corporation should also be able to exchange out of one property into multiple other properties and then do a tax-free division. After a corporate division, the resulting entities will be corporations. Continued corporate ownership is not the ideal structure of real property (the owners would probably prefer to own the properties in tax partnerships), but a tax-free division does allow the owners to go their separate ways. Tax-free divisions of corporations have several technical requirements, so do them with care to ensure all the technical requirements are satisfied.

14. Recognize you're not a DST, NNN, or TIC broker

A significant marketplace exists for packaged replacement property, such as DSTs (interests in Delaware statutory trusts), NNNs (triple-net properties), and syndicated TICs. Each of these products provides passive investments for parties looking for real estate interests and minimal management responsibilities. For instance, triple-net properties are typically stand-alone properties with credit tenants. Exchangers often transfer out of property they have owned and managed and with which they are familiar into triple-net properties with which they have little or no familiarity. Some exchangers will visit such properties before acquiring them; others buy them sight unseen relying solely on financial information provided by the seller and the tenant's credit worthiness.

DSTs have become a popular form of replacement property. They allow investors to buy a fractional interest in a larger property or properties. A DST is a legal entity that tax law disregards if the DST satisfies certain requirements that create a fixed investment for members of the DST. The fixed investment requirement prohibits the DST from refinancing, making significant structural improvements to, or negotiating new leases for its property. Those restrictions should generally limit DSTs to owning new construction or recently renovated property. When property owned by a DST reaches a point that requires renovation, the DST must sell it.

Syndicated TICs were popular in the 2000s prior to the financial crisis, but they have lost their luster. An investor could probably find a syndicated TIC to invest in, but sponsors and lenders prefer DSTs because they employ a separate legal entity.

Investors should note how COVID-19 affects these types of arrangements. Rent payments and other revenue from the properties might decrease significantly for some types of properties, such as student housing, office buildings, and hotels. Reportedly, sales of DSTs that were on the market before COVID-19 have slowed. Loss of rent revenue will affect DST distributions. The situation at the time of this writing is worrisome for parties in the DST space. The speed at which the economy returns to normal will affect recovery of this market segment.

Real estate lawyers should be familiar with the legal aspects of TICs, DSTs, and triple-net replacement properties, but they should be careful not to promote any particular property. The industry is effective at getting their product in front of potential investors. Attorneys should be sure that any advice they give with respect to potential replacement property is within the scope of their representation, and they should recognize that not all products or sponsors adhere to the same standards of care and quality. Attorneys should also remember that their ethical duties require them to represent the client and should be certain any product their client is considering complies with section 1031 or other tax rules relevant to the transaction.

15. Use caution if replacement property comes from a related party

The IRS and courts do not like exchangers acquiring replacement property from related parties and generally deny section 1031 nonrecognition to such transactions. Courts have decided several cases with such facts, and the exchangers have lost in every case. The related-party exchange rules provide a defense for exchanges that are not tax motivated. Perhaps an exchanger could argue for the application of this no-tax-avoidance defense if the related party recognizes gain and pays more tax on more gain than the exchanger defers. An exchanger typically would not acquire property from a related party if the acquisition would not yield greater tax savings, so this no-tax-avoidance defense typically will not be available. If the related party recognizes gain but has losses to offset the gain, courts do not appear willing to grant the exchanger nonrecognition of gain on the exchange, even if the related party's recognized gain exceeds the exchanger's deferred gain.

16. Know that serial exchanges are an exception to the general related-party prohibition

One exception to the rule prohibiting the acquisition of replacement property from a related party is a transaction in which the related party uses the proceeds to do its own exchange. With such transactions, the IRS has privately ruled that the exchanger's and related party's exchanges can qualify for section 1031 treatment. The related party can also acquire its replacement property from a second related party if the second related party does a section 1031 exchange. An ownership structure with several properties owned in several different related tax entities such as a large REIT or real estate fund, could string several exchanges together with a series of connected exchanges. The ability to string exchanges together in this manner gives these structures the appellation "serial exchanges" or "daisy-chain exchanges."

The benefit of serial exchanges should be obvious. If the related-party group is considered a single economic unit, then serial exchanges allow the economic unit to extend the 45-day identification period and 180-day exchange period indefinitely. If an exchanger anticipates it will not be ready to complete the exchange within its 180-day exchange period, it can identify a related party's property and acquire it prior to the end of the 180-day period. The related party then has 45 days to identify replacement property and 180 days to acquire it. If the related party is concerned that it won't be able to acquire replacement property within its 180-day exchange period, it can identify another related party's property and keep the chain going by acquiring replacement property from that other related party. The possibility of benefitting from serial exchanges may prompt some property owners to structure ownership of multiple properties with multiple related entities. Creating related parties to own separate properties can also lay the groundwork for doing leasehold improvement exchanges.[6]

17. Selling to a related party is probably fine

The IRS allows exchangers to sell relinquished property to a related party and do an exchange (through a QI) with the proceeds the related party pays for the property. Knowing this can come in handy if the exchanger is considering doing a so-called Bramblett exchange in which it locks in capital gain treatment on property held for investment before selling it to a related-party developer.[7] The investment entity in such a transaction should be able to use the proceeds from the sale to the related-party developer to do a section 1031 exchange (if the developer entity acquires the property with a note, then the transaction will require additional planning). There may be other reasons for selling property to a related party as part of a section 1031 exchange, so be aware that the IRS has sanctioned such transactions.

18. Know when the exchange period ends

The exchange period runs until 180 days after the exchanger transfers the relinquished property. That period can be cut short if the tax return due date for the year of the exchange is before the end of the 180-day period. Know that your client can avoid having the 180-day period cut short by filing an extension. Thus, if an exchange starts towards the end of the taxable year (assuming a calendar taxable year) and the 180-day period will end after March 15, if the exchanger is a partnership or S corporation, or after April 15, if the exchanger is an individual or C corporation, let your client know to file an extension to get the full benefit of the 180-day period, assuming the exchanger needs additional time to complete the exchange. Due to COVID-19, the 2020 filing deadlines between April 1 and July 15 have been extended until July 15.[8] Such extensions are not typical, but when they happen they could be relevant to the exchange period. If the exchanger prefers to receive exchange proceeds and not continue the exchange, advise the exchanger to not extend the return and to not take advantage of any extension relief. When the exchange period ends, the (g)(6) restrictions cease to apply.

The 180-day period can only be extended by the IRS for a limited number of reasons, which require other federal action, such as a federally declared disaster.[9] Absent such an extension, the 180-day period is definitive, and it can end on a holiday or weekend, so be sure to close on property before the end of the exchange period, if necessary.

19. Follow the money: replace value, replace equity

Cash is king in section 1031 exchanges, just like it is with most other things, because an exchanger's actual or constructive receipt of cash will trigger gain recognition. Real estate attorneys should pay close attention to the flow of funds, ensuring that proceeds from the sale of relinquished property get to the QI and get used to acquire replacement property. To totally defer gain, an exchanger must acquire replacement property that is equal to or greater in value than the relinquished property (the equal-value rule), and the equity (value of the property minus the debt encumbering it) in the replacement property must be equal to or greater than the equity in the relinquished property (the equal-equity rule). Thus, if the relinquished property has debt, the exchanger can defer all of the gain on the sale of that property only by replacing the debt or putting additional capital into the acquisition replacement property.

Often, acquisition financing will include funds for capital improvements to the replacement property. In such situations, the sum of the loan proceeds and exchange proceeds coming to closing might exceed the value of the replacement property (perhaps the extra proceeds will be used for capital improvements), but the exchanger must comply with the equal-value rule and the equal-equity rule to avoid gain recognition. Assuming the replacement property satisfies the equal-value rule, the exchanger can satisfy the equal-equity rule only by ensuring that all of the exchange proceeds are used to acquire the replacement property and any extra cash comes from financing. The most conservative way to ensure that the extra cash comes from a loan is to close on the replacement property and then enter into a new loan for the extra proceeds. Often that course of action is not feasible because the lender will only do one set of loan documents and is not interested in delaying the distribution of proceeds. A next-best course of action is to ensure that the closing statement clearly identifies the exchange proceeds being used to acquire the replacement property and that any cash the exchanger receives comes from the loan.

At a courtesy meeting with the IRS as part of the American Bar Association Tax Section meeting in May 2019, attorneys at the IRS Chief Counsel's Office indicated that tracing exchange proceeds from the QI to seller and loan proceeds from the lender to exchanger is acceptable. They suggested that as long as the exchange satisfies both the equal-value rule and the equal-equity rule (the loan proceeds received by the exchanger at closing would not be considered debt for purposes of computing the property's equity), the cash received at closing should not be treated as boot. Although such communication is not an authoritative statement of law, it did give confidence to the practitioners present at the meeting to move forward with such transactions when no other alternatives are feasible.

Real estate attorneys should also be mindful that closing adjustments can have tax consequences. Transaction costs, such as attorneys' fees, transfer taxes, QI fees, brokers fees, and survey and engineering fees, paid at closing reduce the amount realized of sold property or increase the basis (i.e., cost) of acquired property (in the case of purchased property, but use of exchange proceeds to pay those costs should not affect the basis of property acquired in an exchange), so they do not affect the taxability of an exchange. Adjustments for prepaid rent, taxes, security deposits, and other items can have tax consequences. Any exchange proceeds used to pay such items for the seller will be boot to the seller. If the items are deductible, the deduction will offset the boot, but if the parties can ensure that the exchange proceeds go to the QI and the adjustments get paid outside the closing, the seller could take the deduction against other income.

In the case of security deposits transferred to the buyer, if the deposits are paid out of exchange proceeds through a credit to the purchase price, the buyer would most likely have boot and have no offsetting current deduction. In such a situation, the buyer should insist upon having the seller write a separate check to transfer the security deposits. Real estate attorneys should take the closing statement seriously and identify any items that could trigger boot. Some exchangers may prefer to settle those items on a separate closing statement and use proceeds from sources other than the exchange proceeds to pay for those items.

20. Have the best section 1031 people in your contacts folder

Section 1031 has become commonplace and many real estate attorneys have done dozens, hundreds, or even thousands of section 1031 exchanges. Such attorneys are very familiar with the section 1031 exchange process, but many exchanges involve complex tax matters or tax issues outside of section 1031. Get a section 1031 expert on board whose expertise covers section 1031 and other relevant areas of tax law to ensure that all technical requirements are satisfied and other tax issues are considered.

Section 1031 can be a wonderful tax-saving device. Some exchanges seem routine, and you may feel comfortable relying solely on the QI for tax advice regarding your exchange. Use caution in doing so. Qualified intermediaries generally include disclaimers in their documents and marketing materials providing notice that they do not provide tax advice. If they are not your client's attorney their communication may not be protected by the attorney-client privilege, and the QI may not be subject to the rules of ethics that govern attorneys.

Qualified intermediaries will become disqualified if their advice extends beyond advice with respect to exchanges intended to qualify for section 1031 nonrecognition.[10] The QI rules do not establish the parameters of what constitutes advice with respect to an exchange intended to qualify for section 1031 nonrecognition, so one cannot know with certainty if a QI crosses that line. If the advice is limited to the identification rules and the identification and exchange periods, then most observers would agree that the advice is with respect to an exchange intended to qualify for section 1031 non-recognition. If the advice relates to whether a TIC is a partnership or whether a drop-and-swap qualifies for non-recognition on both the distribution and the exchange, then the advice may cross the line and relate to classification of an arrangement and tax treatment of a partnership transaction. If that happens, then the QI safe harbor could cease to apply, and the exchange may not qualify for nonrecognition.

To avoid those problems and ensure that all aspects of a section 1031 are properly considered and applied, recommend that your client hire a section 1031 expert to assist with the exchange. Even when the exchange seems simple, if the dollars justify hiring an expert, don't take chances—get an extra set of expert eyes to review the exchange. It can't hurt to have a set of trained eyes review every aspect of the exchange. If the transaction is complex, definitely suggest that your client enlist expert help to assist with planning and executing the transaction. The cost of such help will be slight compared to the cost of defending problems that arise from oversight or neglect of important issues.

Conclusion

Section 1031 is a great tax-saving mechanism and section 1031 exchanges are ubiquitous. Real estate attorneys are on the front lines of exchanges. They should be mindful of situations that lend themselves to section 1031 treatment and help their clients understand the benefits of section 1031 deferral. Real estate attorneys should also be aware of issues that come up in section 1031 exchanges and be prepared to handle those issues or bring in tax specialists to help with those matters. Interesting and perplexing issues can arise even in what appear to be straightforward, simple exchanges. By being mindful of the 20 issues discussed in this article, real estate attorneys can help reduce the risk of overlooking a relevant issue or matter and help ensure that an intended exchange obtains the tax goals the exchanger is pursuing.

Notes

1 See Bradley T. Borden, "20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10)," in the May issue of The Practical Tax Lawyer.

2 For an in-depth discussion of extensions of the section 1031 periods, see Bradley T. Borden, "Universal Deadline Extensions Draw Attention to Section 1031 Periods," 167 Tax Notes Fed. 603 (Apr. 27, 2020). See also American Bar Association Section of Taxation, "ABA Tax Section Follows Up on Preliminary COVID-19 Remarks," 2020 TNTF 85-21 (Apr. 29, 2020); Letter from Real Estate Coalition Requesting Clarification of Disaster Relief for § 1031 Exchanges (Apr. 20, 2020), available at https://v6k8u5d3.stackpathcdn.com/wp-content/uploads/2020/04/LKE-Coalition-letter-to-Treasury-IRS-re-Notice-2020-23-4.20.20.pdf?x44329..

3 See Kristen A. Parillo, "FAQ Coming on Like-Kind Exchange Extensions," Tax Notes Federal, Apr. 20, 2020, p. 527.

4 For an in-depth discussion of those cases, see Bradley T. Borden, "Section 1031 Drop-and-Swaps Thirty Years after Magneson," 19 J. Passthrough Ent. 11 (Jan.-Feb. 2016).

5 See I.R.C. § 355; Treas. Reg. § 1.355-1, -2.

6 See Bradley T. Borden, 20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10), supra; "Build-to-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment," 98 J. Tax'n 22 (Jan. 2003) (with Alan S. Lederman and Glenn Spear).

7 See "Accounting for Pre-Transfer Development in Bramblett Transactions," 41 Real Est. Tax'n 162 (3rd Quarter, 2014) (with Matthew E. Rappaport); "A Case for Simpler Gain Bifurcation for Real Estate Developers," 16 Fla. Tax Rev. 279 (2014) (with Nathan R. Brown & E. John Wagner, II).

8 See I.R.C. 7508A; Notice 2020-23, 2020-18 I.R.B. 1; Rev. Proc. 2018-58, 2018-50 I.R.B. 990.

9 See id.

10 See Treas. Reg. § 1.1031(k)-1(k).