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Don't Forget to Park!
Qualified Intermediary Sued For Botched Like-Kind Exchange

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Like-kind exchanges under section 1031 of the Internal Revenue Code provide taxpayers with the vital ability to dispose of real property tax-free. Unfortunately, like-kind exchanges are rarely as simple as directly swapping one property for another. Much more common are more complex multiple party "deferred" or "reverse" exchanges in which the disposition of the relinquished property and the acquisition of replacement property are not simultaneous. A recent lawsuit involving a real estate owner that sued its qualified intermediary provides an all-too-common example of a dismayed taxpayer that unexpectedly recognized gain as a result of the improper structuring of a like-kind exchange.

Background

Section 1031 provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if it is exchanged solely for property of a "like kind" which is to be held for productive use in a trade or business or for investment. If a transaction would have been tax-free under section 1031 but for the fact that the taxpayer receives both qualifying replacement property and "boot" (e.g., money or non-like kind property), then the taxpayer recognizes gain from its disposition of the relinquished property to the extent of the boot received.

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All real property, whether unimproved land or a skyscraper, is generally considered "like-kind" with respect to other real property for purposes of section 1031. However, the IRS takes the position that improvements constructed by a taxpayer on land owned by the taxpayer do not constitute qualifying "like-kind" replacement property.

Section 1031 and the Treasury Regulations thereunder expressly permit both simultaneous and deferred like-kind exchanges. In a deferred exchange, the property sold by the taxpayer (the "relinquished property") is transferred by the taxpayer through an unrelated third party (the qualified intermediary, or "QI") prior to the taxpayer's acquisition of new property (the "replacement property") in the exchange. Replacement property must be identified within 45 days of the transfer of the relinquished property and must be acquired within 180 days of such transfer (or prior to the due date of the taxpayer's return, including extensions, if earlier). In a successful exchange, the replacement property is acquired with funds from the exchange account, and title to the replacement property is transferred directly to the taxpayer (at the direction of the QI).

A taxpayer is not always in control of the timing of the closings comprising the exchange, and may not be able to sell the relinquished property before acquiring the replacement property. The Code and the Treasury Regulations do not expressly permit a "reverse" exchange (i.e., where the replacement property is acquired first). However, a reverse exchange can qualify under the safe harbor set forth by the IRS in Revenue Procedure 2000-37 by engaging an unrelated third party (referred to as an exchange accommodation titleholder, or "EAT") to acquire the replacement property for the taxpayer. Under one format sanctioned by the Revenue Procedure (referred to as the "Exchange Last" parking format), the replacement property remains "parked" with the EAT until the taxpayer disposes of the relinquished property (through the QI), at which time the EAT transfers the replacement property directly to the taxpayer (at the direction of the QI).

The EAT can hold the applicable property for a maximum of 180 days. During this period, the taxpayer is able to retain economic control of the parked property through a lease or management agreement with the EAT. For income tax purposes, the EAT is treated as the owner of the property, which is critical for the qualification of the like-kind exchange, but the EAT generally is the taxpayer's agent for other purposes.

Kreisers, Inc. v. First Dakota Title Limited Partnership

The recent South Dakota circuit court case of *Kreisers, Inc. v. First Dakota Title Limited Partnership* considered a lawsuit by Kreisers, Inc. ("Kreisers") and its shareholders against First Dakota Title Limited Partnership ("First Dakota"), the QI that Kreisers had used for a like-kind exchange. Kreisers (an S corporation) had intended to carry out a like-kind exchange for which the replacement property would consist of vacant land that it would acquire (the "Industrial Park Property") as well as improvements which would be constructed on this land. Representatives of First Dakota, however, had no recollection of anyone at Kreisers mentioning an intention for the replacement property to include improvements constructed on behalf of Kreisers. First Dakota's policy was not to handle any like-kind exchanges pursuant to which improvements constructed by the taxpayer constitute replacement property (referred to as "construction exchanges" or "build-to-suit" exchanges).

On April 16, 2007, Kreisers sold its real property to a third party through First Dakota as QI for $765,000, which was transferred to Kreisers' exchange account with First Dakota. The closing on the Industrial Park Property, which was identified as replacement property for the like-kind exchange, occurred on April 19 and 20, 2007. As orchestrated by First Dakota, cash from the exchange account was used to acquire this vacant land, and title was transferred directly to Kreisers. Approximately $320,000 remained in the exchange account after this acquisition, which Kreisers intended to spend on improvements within the 180-day replacement period. Unfortunately for Kreisers, the fact that it had already taken ownership of the Industrial Park Property precluded any improvements that it would construct thereon from qualifying as replacement property for the like-kind exchange.

On June 30, 2007, Kreisers informed First Dakota that it wanted to use some of the remaining funds in the exchange account to pay the contractor for improvements made to the Industrial Park Property. James Rogers, a manager at First Dakota, informed Kreisers that the like-kind exchange had not been structured as a construction exchange and that improvements built by Kreisers on the land that it had acquired did not qualify as replacement property for the like-kind exchange. A telling e-mail sent by Rogers lamented "how much I really hate doing these darn 1031s."

Kreisers ended up recognizing gain equal to its $320,000 of "boot" on the exchange (i.e., the amount of unused funds in the exchange account). Kreisers and its shareholders sued First Dakota for the $172,804 of tax liability which they claimed to have recognized as a result of this gain. This figure included both (a) tax liability incurred by Kreisers (an S corporation) with respect to its recognition of built-in-gain from when it previously was a C corporation and (b) pass-through tax liability incurred by the shareholders of Kreisers.

The court found First Dakota liable for negligence based on the fact that it had held itself out as being skilled in carrying out 1031 exchanges and either knew or should have known to structure the exchange as a proper construction exchange (described below). The court seemed particularly bothered by the fact that the representatives of First Dakota had not used any checklists to make sure that they had ascertained all relevant information and that First Dakota had not provided the documents to Kreisers for its review prior to closing. However, the court agreed with First Dakota's expert that the damages should be reduced to take into account (a) the present value of additional depreciation deductions that Kreisers would receive as a result of its higher basis in the constructed improvements and (b) the benefit to the shareholders of Kreisers (an S corporation) from the increase in the basis of their stock (which would reduce the future gain recognized upon sale of their stock).

Analysis

How should Kreisers' "construction exchange" have been structured? Since the IRS takes the position that improvements constructed by a taxpayer on land owned by the taxpayer cannot be qualified replacement property, Kreisers should not have taken ownership of the Industrial Park Property until after the construction of the improvements which it intended to qualify. Rather, the Industrial Park Property should have been acquired by an EAT with funds provided to the EAT by Kreisers. Under the safe harbor of Revenue Procedure 2000-37, the EAT (and not Kreisers) would have been treated as the beneficial owner of the Industrial Park Property while the improvements were constructed. As a result, improvements constructed on the Industrial Park Property during the applicable 180-day period would have qualified as replacement property for the like-kind exchange. Prior to the expiration of the 180-day period, the Industrial Park Property (including both the land and the constructed improvements) would have been transferred by the EAT to Kreisers at the direction of the QI.

The improper structuring of Kreisers' construction exchange highlights the reality that like-kind exchanges often involve a great deal of complexity and that there are countless traps for the unwary which can cause the failure of a like-kind exchange. While First Dakota's error in the structuring of Kreisers' exchange was blatant, subtle details can often determine whether or not a like-kind exchange will stand up on audit as being tax free.

First Dakota's biggest mistake, though, was probably the very fact that it held itself out as an expert in structuring like-kind exchanges upon which Kreisers could rely. More than anything else, this case provides real estate owners considering a like-kind exchange with a stark reminder of the necessity of getting tax advice.