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Real Estate Report

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Reverse Tax-Deferred Exchange: You can do that?

By: Brad Gai, Stockholder

The short answer is "Yes you can." The actual use of this tax deferral approach under IRC Sec. 1031 has limited application but important benefits for those taxpayers that are in a position to use it. A recently decided Tax Court case illustrates how this can work. The Tax Court's Opinion in the Estate of George H. Bartell, et al. v. Commissioner was issued August 10, 2016. The events that started this case date back to May 7, 1999. The Tax Court deciding this case is in the 9th District Court for Appeals, so the judges in the case were mindful of prior decisions in the 9th District in particular. (The 9th District covers California and several other western states.)

This tax deferral approach, sometimes referred to as a "parking transaction", has limited application because the taxpayer must have the ability to purchase the replacement property through an accommodator or exchange facilitator before selling the property to be exchanged. Most taxpayers need the funds from the sale of their property to fund the purchase of the replacement property. This tax deferral really does favor the well heeled over the merely well off.

Here is a very brief summary of the case:

The taxpayer, Bartell, purchased land known as Lynnwood in May 1999 through a facilitator, also known as a third party accommodator, to build a retail store, in this case a pharmacy in Washington State. Bartell then arranged for bank financing for the construction. The construction loan was managed by the facilitator, although Bartell made the construction decisions. The acquisition of the land had a closing date of August 1, 2000. Construction was completed in July 2001. The facilitator leased the property to Bartell for several months while the sale of the property to be exchanged was completed. Bartell entered a sale agreement through a facilitator on September 21, 2001 to sell Everett, the property to be exchanged. The sale of Everett was to an unrelated party in a sale and leaseback arrangement. Everett included an existing pharmacy location. The facilitator closed the sale of Everett on December 28, 2001 and the exchange escrow for Lynnwood was closed on December 31, 2001.

After all of the transactions and construction was completed, Bartell was able to sell one existing pharmacy property but retain its operations at that location through a lease, and Bartell was able to open a new pharmacy location that it now owns. The loan from the bank to fund construction was paid off from the proceeds of the sale of Everett.

The IRS issued Revenue Procedure 2000-37 which explains the reverse exchange process after the Bartell transactions were initiated in 1999. The IRS guidance in this Revenue Procedure provides taxpayers with "safe harbor" guidelines to follow to avoid any controversy with reverse exchange transactions. One of the guidelines requires the exchange of the relinquished property and the replacement property to be completed within 180 days. This is in contrast to the 17 month gap between the purchase of Lynnwood (8/1/2000) and the sale of Everett (12/31/2001) in the Bartell case.

The IRS argument with the result in the Bartell case centered on the degree of control that Bartell had over the financing and construction process as well as the pre-exchange possession of the property through a lease for the Lynnwood property from the facilitator. In effect, Bartell "owned" the Lynnwood property the IRS argued.

The Tax Court followed prior case law where the intent of the taxpayer to enter into a tax-deferred exchange is clear from the beginning and the taxpayer uses a third party facilitator to take title of the property in the exchange, the facilitator did not have to assume the benefits and burdens of ownership to be treated as the owner for the purposes of the exchange under IRC Section 1031. The temporary possession of the property by Bartell through a lease with the facilitator and the long holding period did not change their conclusion.

The Tax Court made a point of the importance of using a facilitator in the Bartell case. This case cites other cases where taxpayers had not used a facilitator and those when a facilitator was used. The use of a facilitator is essential to a successful reverse tax-deferred exchange or any tax-deferred exchange. The Bartell case opens the door to reverse exchange transactions that are outside the IRS safe harbor guidelines.

Tax & the Modern Homeowner

By: Amy Conger, Tax Manager

What was once considered a traditional household — a married father and mother with a couple of kids — is quickly becoming just one type of lifestyle. The number of unmarried people entering home ownership together is on the rise, and with it, a new set of tax issues to consider.

In the co-purchasing landscape, it's vital to first consider which form of ownership works best for each individual, either as tenants in common or joint tenancy.

- **Tenancy in common:** With tenancy in common, owners are allowed to sell their own interest without the consent of the other co-tenants, which also means a co-tenant can't sell or transfer the others interests. They share in the appreciation or depreciation value of the property, and are responsible for upkeep and maintenance costs according to their ownership interests. With tenancy in common there are no survivorship rights to the surviving owner.
- **Joint tenancy:** With joint tenancy each individual equally owns an undivided interest and consent must be universally agreed upon whenever an action concerning the property is made. In a joint tenancy agreement there are survivorship rights, and the property doesn't need to pass through a will or enter probate.

Once ownership is established the owners receive the property title. If the property is transferred from one party to another — like in the case of survivorship — the new owner is given a deed. Here are the two most common types of deeds:

- **Warranty deed:** This is where the seller provides a number of guarantees to the buyer and gives a complete description of the property and buyer's assets. It also assures a clear title free of liens and other potential issues.
- **Quitclaim deed:** This is often used when the property is transferred through a will, gift or part of a divorce settlement. There are no guarantees included, which can be tricky if the parties don't know each other well or don't have a trustworthy relationship.

Your home provides many tax benefits from the time you buy it right on through to when you decide to sell. Here are some common homeowner related tax deductions.

- **Mortgage interest:** Presently Sec. 163(h) allows homeowners to reduce their taxable income by the amount of interest paid on their real estate loan. Joint ownership does not always necessarily mean a joint mortgage. Generally you must be liable on the note to claim the interest deduction, however, if you can prove equitable ownership, you may be able to claim the deduction under Reg. 1.163-1(b).
- **Real estate tax:** The legal owner or owners are generally entitled to a tax deduction for their property taxes. The differing forms of ownership and jurisdictions can affect the amount deductible by each owner.
- **Indirect gifts:** If one party pays property taxes on behalf of another property owner, it can create a situation where it results in a gift from one party to another. In this situation the party who paid the entire tax bill can still only claim their portion of the deduction since they gifted the cash to pay for the other party.

Other common tax issues:

- A co-owner cannot claim a mortgage interest deduction if they are not living in the residence unless the property is a second home or investment.
- When unmarried co-owners sell their full or partial property interest to one another, it is still a taxable sale. However, the $250,000 homeowner exclusion may still apply to exclude the gain.
- When a casualty loss or theft occurs on a property, the deduction is divided on the basis of each individual's portion of ownership.

This is just the tip of the iceberg of things to consider when venturing into a non-spousal homeowner agreement. Something that is vital to a stress-free partnership is to create a document that covers all aspects of your desired home sharing arrangement. This includes a buyout strategy, decision to sell, refinance, remodel, and what to do if one of the owners goes through bankruptcy or passes away.

To achieve the most beneficial tax result, homeowners and their tax advisers should understand not only the tax rules but also how the home is financed, who owns the home, and who pays the home-related costs. Professional advice provided to the taxpayers before they enter into the transaction can significantly improve the tax results.

Real Estate Advice Series Seminar

SLAM: Strategic Lifetime Asset Management

Tuesday, May 16, 2017
8:30 am to 10:00 am

Scott's Seafood Restaurant
1333 N. California Blvd.
Contra Costa Room
Walnut Creek

Our Speaker
Greg Gagon, Managing Director
Real Property Tax Incentives Company

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