M E M O R A N D U M

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“Avoiding the hot potato: Cash in like-kind exchanges”

Using cash in a like-kind exchange is similar to passing around the proverbial “hot potato” – you don’t want to be the one holding the potato, i.e. the cash, at the end of the transaction. If you do so in a like-kind exchange, you are probably holding “boot” (non-qualifying property), which is taxable to the extent of any gain otherwise locked up in the relinquished property (i.e., the difference between its fair market value and basis).

Sometimes, strategies that involve the use of cash to facilitate like-kind exchanges under the Internal Revenue Code of 1986, as amended Section 1031 begin to seem like shell games, in which labels matter a great deal. In the end, however, the only labels that have been successfully applied are those that have made sense within the basic framework of Section 1031.

This memorandum reviews a variety of tax results when cash is used within the structure of a like-kind transaction. To hold these divergent uses of cash together, we have recommended 10 rules to keep in mind whenever cash is proposed as part of a like-kind exchange.

Some basics

Non-qualifying property, or boot, as well as qualifying property, may be part of a like-kind exchange. Boot is often given to equalize the value of the like-kind properties being exchanged. Boot is often given to equalize the value of the like-kind properties being exchanged. Boot may consist of cash, relief from indebtedness, excluded property, or property that is not like-kind to the property being exchanged.

The recipient of boot (cash and non-like-kind property) by a taxpayer in an otherwise qualifying exchange of like-kind properties generally means that gain must be realized to the extent of the value of the boot received. The receipt of cash in a like-kind exchanged has realized gains. There is no prorata division of gain between cash received and the fair market value of property received in the exchange.

- **Rule No. 1: Don't touch the cash if possible.** It is critical that the taxpayer never receive cash (or as little as possible) for the property, either actually or constructively. A sale of property for cash and a reinvestment of money in similar property does not constitute a qualified Section 1031 exchange. If a taxpayer receives control over cash in a transaction, like-kind exchange treatment is denied, even though at the end of the transaction the taxpayer holds like-kind property.

If the sale and reinvestment are dependent upon each other, the step transaction doctrine may save the day by treating a sale as an exchange. But that argument is an uphill battle that is best avoided.

- **Rule No. 2: Balance the financing, but with cash going outbound only.** If the exchange involves the reciprocal assumption of mortgages or reciprocal transfer of property subject to mortgages, the taxpayer is permitted to offset the amount of debt relief by the amount of debt assumed. The taxpayer has boot from the relief of the liability only to the extent that the debt relief is greater than the debt incurred.

This "balance" may be achieved not only through offsetting liabilities, but also by offsets of liabilities assumed by cash or other boot property transferred by the taxpayer (rather than to the taxpayer) in the exchange. For example, Smith exchanges X (property subject to a $100,000 mortgage and cash of $440,000) for Y (like-kind property subject to a $60,000 mortgage). Smith has no boot and recognizes no gain on the exchange.

Cash cannot travel the other way, however, that is, to the taxpayer wanting Section 1031 treatment. Only relief-of-indebtedness boot can be offset by the other forms of boot transferred in the exchange. Other boot received cannot be offset by the boot given.

For example, say that Smith exchanges S (property subject to a $60,000 mortgage) for T (Thompson's like-kind property subject to a $100,000 mortgage and cash of $40,000). Smith's relief of the liability of $60,000 is completely offset by the assumption of the $100,000 liability. The $40,000 cash that Smith receives results in boot of $40,000 that is not offset (as far as the ability to defer gain under Section 1031) by Smith's assumption of a greater liability. However, watch the hot potato! If Smith had Thompson use the $40,000 cash to reduce the $100,000 mortgage before the exchange, Thompson and Smith would each exchange like-kind properties subject to a mortgage of $60,000, and neither would recognize any gain in the exchange.

Rule No. 3: Any cash received can be made harmless if it is contractually locked in for debt reduction. The Tax court has allowed cash to flow the other way in our example, too, if there are contractual "lock ins." In one case (E.T. Barker v. Commr., 74 TC 555), a cash advance received by a taxpayer for the purpose of paying off a mortgage on a property being transferred in the exchange was allowed to be netted against boot given by the taxpayer in the exchange.

This holding, however, is limited to situations in which the taxpayer has been bound contractually to use the cash to satisfy the mortgage liability.

A word of caution: If a taxpayer borrows against the relinquished property in anticipation of a like-kind exchange, the Internal Revenue Service may view this as the receipt of boot, in the same way that such a borrowing is deemed a payment in the year of sale under the installment sale rules. Borrowing against the replacement property immediately after the exchange, however, should not create any such problem.

Rule No. 4: Cash coming in may be made harmless if considered as a repayment of a loan. If the newly created debt represents repayment of funds advanced by the taxpayer to aid in the acquisition of the exchange property, the debt is treated as reimbursement, rather than boot.

For example, a taxpayer advanced cash for the acquisition of property that he was to receive in an exchange. When he received the property, he also received cash and a promissory note. The court treated the cash and note as repayments of the loans, and not as boot.

Rule No. 5: Cash used to facilitate multiple buy-and-sell arrangements is netted. If multiple assets and boot are exchanged, it is necessary to allocate the boot received among the properties given to determine the amount and character of gain on the transfer.

If the exchange constitutes the transfer of a trade or business, a residual method of allocation must be used for property not treated as transferred for the like-kind assets, and the allocation must be reported to the IRS. Under the residual method, the consideration received is allocated first to cash.

Rule No. 6: Cash commissions can decrease gain, but not increase loss. Cash paid to a third party as commission on the transaction is netted against cash received to reduce the gain realized. If the payment produces a loss, no deduction is allowed. Although an assumption of a liability can be used to offset the taxpayer's relief from liabilities, the creation of a liability between the parties cannot be used as an offset.

Rule No. 7: Use QI instead of an agent to deal with cash. Qualified intermediaries may be used to purchase other property before completing an exchange. Taxpayers can participate in the acquisition of other property and qualify for like-kind treatment if the taxpayer has no actual or constructive receipt of cash proceeds from the sale of their property. Multiple parties can be involved. Cash can float around everywhere else, but as long as it does not land with the taxpayer, taxable gain is avoided.

A taxpayer is not in actual or constructive receipt of money or other property before he receives replacement property, simply because the obligation of the other party to the transaction is or may be secured by cash held in a qualified escrow account or in a qualified trust.

Rule No. 8: Use of the installment sale rules may postpone recognition of boot. While there is often a direct relationship between the amount of cash received and the amount of gain that must be realized, that realization may be postponed by combining a like-kind exchange with the use of the installment sales method. Gain recognized in a like-kind exchange because of boot can be postponed under the installment sale rules if at least one payment is due after the year in which the exchange occurs.

A taxpayer that received a transferee's obligation to transfer replacement property in a deferred like-kind exchange does not treat the obligation as a payment for the purposes of the installment sales rules at the time that cash is sent to the QI or used by the QI. This rule allows the taxpayer to carry out deferred like-kind exchanges without risk that the presence of cash or equivalent held in a qualified escrow account or qualified trust, or by a qualified intermediary, might require a transferor to recognize gain under the installment sale rules.

Rule No. 9: Related-party transactions more easily violate cash-out rules. In general, taxpayers engaging in like-kind exchanges with related parties will not qualify for non-recognition treatment if, within two years of the date of the last transfer, either the taxpayer of the related person disposes of the property. In addition, transactions structured to avoid this rule will not qualify for non-recognition treatment.

One of the main purposes behind this rule is to prevent cashing out by related parties. In a cash-out, related parties make like-kind exchanges of high-basis property for a low-basis property in anticipation of a sale of the low-basis property.

To further prevent abuse, related persons may not act as qualifies intermediaries or otherwise facilitate a like-kind exchange. In addition, several recent transactions in which related parties used QIs to circumvent the related-party rules have been barred from receiving non-recognition treatment. The IRS will look to the end result of these transactions to ascertain whether transactions are structured to avoid taxes.

The Tax Court also took an "end-result" view in Teruya, in which non-recognition treatment was denied for an exchange involving related parties ands a QI (Teruya Bros. Ltd. & Subs, 124 TC 45 (2005)). The court held that the taxpayer used the QI to avoid the related-party requirements and barred non-recognition.

Under the facts of that case, a real estate corporation decided to dispose of some of its property through several like-kind exchanges. It transferred the properties to a QI, who sold them to third parties.

With the proceeds from the sales, the QI acquired replacement property for the corporation. That replacement property, however, had been owned by a subsidiary of the corporation, a related party under the rules. The IRS and the Tax Court stripped the transactions to their essence and determined that the transactions were really an exchange between related parties. From that viewpoint, there was an exchange between the corporation and the subsidiary and a sale to an unrelated person.

In LTR 200616005, however, related parties were involved, but showed a willingness to hold assets for the required two-year period. There, a trust and an S corporation were related persons. The trust planned to transfer Building 1 to a buyer and to acquire Building 2, owned by the S corporation, as replacement property in a like-kind exchange transaction. The S corporation would also exchange Building 2 for other like-kind property. The S corporation and the trust would use a QI to facilitate their exchanges. The QI would be treated as the seller of Building 1 to the buyer and as acquiring Building 2 from the S corporation and transferring it to the trust in exchange for Building 1. The QI would then acquire additional replacement property and transfer that property to the S corporation in exchange for Building 2.

The IRS held that the transactions would qualify for non-recognition treatment. It determined that the exchanges were valid if neither party disposed of the exchanged property for two years. The IRS found that the transaction was not structured to avoid the related-party rules, because the only disposition contemplated by the parties after the trust received Building 2 was the acquisition of replacement property for the S corp to complete the S corp's like-kind exchange.

In sum, both parties would own like-kind property to the one exchanged and there would be no cashing out by either party, so the transaction would qualify for like-kind treatment.

Rule No. 10: Partnership rules complicate cash-outs. A common issue in real estate partnerships comes up when a partnership wants to dissolve and some partners want to cash out, while others want to use part of the assets in like-kind exchanges provisions, transactions involving the underlying assets to qualify.

One way to provide some partners a cash-out is to sell the partnership's real estate, and use some of the proceeds to engage in an exchange and the other portion to pay the partners who want to cash out. However, these transactions may result in all the partners recognizing the gain that is recognized by the partnership.

Partnerships may choose to do special allocations in order to allocate the gain to the partners who want to cash out and none to the ones who want to continue their investment. The problem with special allocations is that they may fail the substantial economic effect test. In other words, rules related to partnerships may frustrate what may otherwise be allowed under the like-kind exchange rules.

Another option would be for the partnership to accept an installment note would allow gain recognition to be postponed. The partnership would distribute the installment notes to the partners wanting to cash out in full redemption of their partnership interests.

Conclusions

Most like-kind exchanges are not perfect fits, and cash in some form usually serves to make up the difference and even out the edges. While gain is usually trying to be deferred, any cash that is recognized as boot will likely be subject to income tax.

As our 10 rules indicate, however, there are many variations of like-kind exchanges in which cash is used, but little or no gain is attributed back to the taxpayer. The drill is to make certain that all the tax implications in using cash are known prior to undertaking the transaction, either to consider restructuring it or to prepare for a big tax bill. We cannot over emphasize preplanning and discussing with us prior to entering into any 1031 exchange.