Larry's Tax Law

Form Over Substance Sometimes Prevails in Tax Law - Estate of George H. Bartell et. al. v. Commissioner

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In most areas of law, substance prevails over form. Code Section 1031 is possibly one of the few exceptions to this time-honored rule of jurisprudence. Under Code Section 1031, form may prevail over substance. The U.S. Tax Court's decision in ***Estate of George H. Bartell, et. al. v. Commissioner***, 147 TC 5 (June 10, 2016), supports this thesis.

Estate of George H. Bartell et. al. v. Commissioner

Case Background

The facts of the case are fairly straightforward. Bartell Drug, an old family-owned chain of retail drugstores located in the state of Washington, was owned by the petitioner and his two children. In 1999, the company entered into an agreement to purchase a parcel of land upon which it intended to build a new drugstore ("Replacement Property"). Bartell Drug had a store located on a property it owned in White Center, Washington, and it anticipated selling this property ("Relinquished Property") to fund, in part, the cost of the Replacement Property. In order to lawfully avoid paying taxes on the gain from the sale of the Relinquished Property, the stage was set for an exchange of real property that would qualify for tax deferral under Code Section 1031. A few obstacles, however, stood in the taxpayer's way, namely: (i) the Replacement Property was found by the taxpayer before a buyer for the Relinquished Property could be found; (ii) the Replacement Property was land without the improvements needed to operate a drugstore (i.e., a building); and (iii) in order to defer all of the gain from the sale of the Relinquished Property, the taxpayer would need to buy the Replacement Property once it was improved.

To overcome these obstacles, the taxpayer carefully planned and carried out the exchange as follows:

1. The taxpayer entered into a written agreement with a qualified exchange intermediary ("QI");
2. The taxpayer entered into a written agreement with an exchange accommodation titleholder ("EAT");
3. The QI agreed to act as the taxpayer's intermediary in the exchange in compliance with Code Section 1031;

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4. The EAT agreed to acquire the Replacement Property and build the improvements on the property (i.e., a new drugstore);
5. The EAT obtained financing arranged by the taxpayer from a bank to fund the purchase of the Replacement Property and to pay for the improvements. The taxpayer guaranteed the loan. It was nonrecourse to the EAT;
6. The written agreement between the taxpayer and the EAT expressly gave the taxpayer the right to supervise and manage the construction of the improvements on the Replacement Property;
7. The written agreement between the taxpayer and the EAT expressly gave the taxpayer the right to lease the newly constructed drugstore once it was completed;
8. The written agreement between the taxpayer and the EAT expressly gave the taxpayer the right to purchase the Replacement Property from the EAT within 24 months for the EAT's cost of acquiring and improving the property;
9. On August 1, 2000, the EAT acquired the Replacement Property. Thereafter, the taxpayer supervised the construction of a new drugstore on the property;
10. The taxpayer leased the improved Replacement Property from the EAT while waiting for the sale of the Relinquished Property. All costs of the property (e.g., taxes, insurance, insurance, utilities) were to be paid for by the taxpayer;
11. Finally, in September 2001, the taxpayer found a buyer for the Relinquished Property and entered into an agreement to sell the Relinquished Property. The agreement was properly assigned to the QI;
12. The QI sold the Relinquished Property to an unrelated party pursuant to the exchange agreement with the taxpayer; and
13. Long after the 180-day safe harbor allowed under Revenue Procedure 2000-37 for a reverse parking exchange, the like-kind exchange was completed when the EAT transferred the improved Replacement Property to the taxpayer.[1]

IRS Contends Exchange Is Ineligible and Applies Benefits and Burdens Test

On audit, the IRS asserted that the exchange failed to qualify for tax deferral under Code Section 1031 on the grounds that the taxpayer was actually the owner of the Replacement Property well before the time when the EAT transferred the Replacement Property by deed to the taxpayer. So, in essence, no exchange occurred because the taxpayer owned both the Replacement Property and the Relinquished Property at the time of the attempted exchange. The IRS used the benefits and burdens test to support its position.

It asserted that, based on the following facts, the taxpayer owned the Replacement Property at the time of the attempted exchange since the benefits and burdens of owning the property were already on the taxpayer:

1. The taxpayer benefited from any appreciation in the Replacement Property's value during the time it was parked with the EAT since it had the option to acquire the property from the EAT at the cost of the

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property;
2. The taxpayer had the risk of loss from any diminution in the value of the property during the time it was parked with the EAT since its option price was pegged to the cost of the property;
3. The EAT had no equity interest in the Replacement Property - if the property went up in value while it was parked, the taxpayer would get that benefit, and if it went down in value, the taxpayer would suffer that loss;
4. The taxpayer (as tenant) paid the real estate taxes and all carrying costs associated with the Replacement Property - all burdens of property ownership were in the lap of the taxpayer;
5. The debt on the Replacement Property was nonrecourse to the EAT but the taxpayer guaranteed the debt - the risk of the debt was solely on the taxpayer; and
6. The improvements being made to the Replacement Property were totally within the control of the taxpayer - the EAT had absolutely no right to control the improvements.

Court Decides Form Over Substance

Judge Gale of the U.S. Tax Court ruled in favor of the taxpayer. The court rejected the IRS's position, refusing to apply the benefits and burdens test since the taxpayer had followed all of the formalities - it had entered into written exchange agreements with the QI and the EAT, it entered into a valid lease agreement with the EAT, the agreements clearly delegated the benefits and burdens relative to the property to the taxpayer, and the agreements were adhered to in all respects. The court went on to conclude that Code Section 1031 is form oriented - form over substance prevails in this instance. The taxpayer was not the formal owner of the Replacement Property at the time of the exchange. So, in this case, the exchange was valid.

Proceed With Caution

Bartell leaves at least one unanswered question - whether a reverse parking exchange may exceed the 180-day period. Because the ***Bartell*** case involved transactions that pre-dated the effective date of Revenue Procedure 2000-37, the court refused to apply the rules contained in the guidance. The court also expressly provided that it is not giving any opinion with respect to a reverse exchange that exceeds the 180-day safe harbor.

This case exemplifies the fact that, in the Code Section 1031 arena, form will prevail over substance. Consequently, taxpayers and their advisors need to be careful to ensure that the exchange documents adhere to the statutory rules. If so, according to the U.S. Tax Court, form will prevail.

[1] The transactions in this case predated the effective date of Revenue Procedure 2000-37.

Posted in 1031 Exchanges, Tax Court, Tax Laws

Tagged as Bartell Drug, benefits and burdens, Code Section 1031, Estate of George Bartell, IRS, Revenue Procedure 2000-37, reverse parking exchange, Safe Harbor, Tax Procedure

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