Current Federal Tax Developments

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SECTION: 166
MONEYLENDING WAS A BUSINESS FOR TAXPAYER, SO DEBT WAS A BUSINESS BAD DEBT

Citation: Owens v. Commissioner, TC Memo 2017-157, 8/10/17

In the case of *Owens v. Commissioner*, TC Memo 2017-157, the issue to be decided involved a $9.5 million bad deduction claimed as a business bad debt an individual who took the position he was in the trade or business of lending money. The IRS argued that he wasn't in the business of lending money, that the debts in question were not actually debts and, even if they were, the loan did not become worthless in the year he claimed the loss.

As the Tax Court summarized the matter:

> Owens argues that he has been in the business of making personal loans on a continual and regular basis for years. He also argues that the loans he made to Lohrey Investments created bona fide debts and that those debts then became wholly worthless in 2008 when West Coast Linen filed for bankruptcy after the trustee padlocked the building in Gilroy. The Commissioner doesn't think that Owens's lending activity amounted to a trade or business and even if it did, the Lohrey loans were more equity than debt. Even if they were debts, they didn't become worthless in the 2008 tax year.

As the Tax Court points that, the issues are those that involve Section 166 which allows a deduction for *bona fide* debt that becomes worthless during a year.[1]

The first issue the Court had to decide was whether Mr. Owens had incurred the debt in the course of a trade or business. If not, any bad debt would be a short-term capital loss.[2] That would limit any deduction for a single year to $3,000 in excess of any net capital gains incurred in the year—and the loss would not lead to a net operating loss deduction.

Mr. Owens claimed he was in the trade or business of lending money and that this loan was made as part of that business. The Tax Court, citing the cases of *Cooper v. Commissioner*, T.C. Memo. 2015-191; *Scallen v. Commissioner*, 2002 WL 31684676, at *9, outlined the following non-exhaustive list of items to be considered in determining if a taxpayer is in the trade or business of lending money:

- the total number of loans made;
- the time period over which the loans were made;
- the adequacy and nature of the taxpayer's records;
- whether the loan activities were kept separate and apart from the taxpayer's other activities;
- whether the taxpayer sought out the lending business;
- the amount of time and effort expended in the lending activity; and
- the relationship between the taxpayer and his debtors.

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[1] Reg. §1.166-1(c)

[2] IRC §166(d)

One complicating factor was that Mr. Owens was involved with a corporation (Owens Financial Group, referred to in the case as OFG) which also made loans—so the question became whether Mr. Owens himself had a money lending activity.

The first test looks at the number of such loans made by Mr. Owens personally. The Tax Court noted that he did have a significant number of personal loans:

> We find that Owens's personal lending activities were continuous and regular by themselves.8 It is clear from the record that from 1999 through 2013 Owens personally (alone, or acting as trustee of Owens Trust) made at least 66 loans (including the Lohrey loans) to a multitude of borrowers, easily exceeding $24 million. These figures are more than sufficient when compared to the benchmark we've set in other cases. Compare *Serot v. Commissioner*, T.C. Memo. 1994-532 (55 loans over 10 years totaling approximately $1.2 million shows business), aff'd, 74 F.3d 1227 (3d Cir. 1995), *Ruppel v. Commissioner*, T.C. Memo. 1987-248, 53 T.C.M. (CCH) 829 (1987) (27 loans over 4 years totaling just under $1.4 million shows business), and *Jessup v. Commissioner, T.C. Memo*. 1977-289 (31 loans over 10 years ranging from $315,000 to $2.7 million each year shows business), with *Cooper v. Commissioner*, T.C. Memo. 2015-191 (12 loans over 6 years not a business).
>
> From 2003 through 2008 — the most crucial years in this case — Owens made approximately 33 loans totaling over $21 million, including $17 million in Lohrey loans. This period was not unusual — money had been Owens's stock in trade since the first days of his career, and lending had long since become his vocation. We are convinced that, over the years, he had fallen into the understandable and prudent habit of lending money raised from the public through OFG to more secured and better risks; the riskier-but-still-promising loans he took on for himself.

The IRS complained that OFG staff kept the records for the loans in question, but the Tax Court found that rather than working against Mr. Owens, this was a fact in his favor, noting:

> OFG treated documentation related to Owens's lending the same as it did its own: It kept a file for each loan that included the underwriting documentation, legal documentation, and any security agreements. OFG kept additional documentation when a borrower was in default, including correspondence, notices, and forbearance agreements. OFG also kept records of existing loans reflecting the balances, summary of payments, and due dates.
>
> Should any of this count against Owens? We don't think so. Remember that the question we're asking is whether his personal lending was a trade or business. The answer to this question is more probably "yes" the more his personal-lending activity looks like the activity of a traditional lender — in contrast, say, to the activity of someone who writes a personal check to his brother-in-law and then bugs him about repaying it every so often. That Owens kept good records of his loans in exactly the same way OFG kept records on its loans very much suggests that Owens was treating his personal lending as a continual and regular activity.

The IRS was also upset that Mr. Owens didn't present a detailed accounting of how much time he spent on the activity, a factor that is often fatal is certain contexts (such as proving qualification as a real estate professional under IRC §469). But in this area, the Court was not nearly as troubled by lack of detailed records, noting:

> Owens testified that he generally spent an average of 50 hours at work each week and did not distinguish the time he spent on lending from his personal funds from the time he spent on lending from OFG's funds. We recognize this as an officially approved factor-to-be-considered but also find that the toilsome drudgery of measuring out one's days in six-minute increments is rarely found among our more entrepreneurial countrymen — they are more inclined to focus on getting the chore in front of them done as efficiently as possible than on keeping detailed time sheets. And on the facts of this case, we find, as we have in similar cases, that Owens had no need to bill specific hours on his personal lending while managing OFG. See *Jessup v. Commissioner*, T.C. Memo. 1977-289. Just look at the number of loans Owens made and how much money he tied up in them — unless motivated by some hidden whimsy or charitable purpose, he spent a sufficient amount of time on them.

The IRS argued that Mr. Owens, since he did not advertise his ability to make personal loans, did not seek out the loans in a way that would indicate he was in the business of lending money. The Tax Court, while agreeing he did not advertise, did not agree this meant he didn't seek out the loans:

> The Commissioner argues, and we do not disagree, that Owens did not advertise his availability to make personal loans. But we also find that he didn't need to any more than the taxpayers in *Serot*, *Ruppel*, and *Jessup*. He had a reputation in the community as a lender and was very well respected. It was clear from the credible testimony of his competition and colleagues that it was his personal reputation that brought borrowers to both OFG and him personally. It wasn't unusual for borrowers to call OFG and ask for Owens directly. We believe the testimony that the professional relationships Owens developed with his borrowers also made it possible for him to continue lending to them.

Having failed to convince the Court so far that Mr. Owens was not in the trade or business of making loans, the IRS now turned to the particular loans and argued that Mr. Owen's actions with regard to the particular loans indicated they were not made in a businesslike fashion since he subordinated his rights to that of another lender after the borrower was already in deep financial distress. But the Tax Court found his actions were that of a prudent businessman noting:

> But we've already found that given his options, Owens did act reasonably. We're being consistent here: In *Ruppel* the taxpayer continued to lend money to a borrower over time because he saw it as the only way to fully recoup his investment. It's easy in hindsight to argue that a lender who kept lending more money to a borrower who ultimately failed was unreasonable. But we try to look at things as the lender saw them at the time, and here we find that Owens's advancing more and more money to a growing and capital-intensive business was reasonable under the circumstances. It turned out to be a bad business decision, but it was a business decision and not charity or lunacy or something else.

Even if Mr. Owens was in the trade or business of lending money, his loss would be capital if there was no *bona fide* debt and what he held was an equity interest. As the Tax Court notes, the line between debt and equity is often "blurry" and each case should be considered based on its own facts.

The IRS argues that the notes, while they may have had stated maturity dates, did not really have any maturity dates since Mr. Owens did not enforce them. But the Court found that Mr. Owens actions in not enforcing those dates were reasonable actions for a lender in this case, noting:

> The Commissioner argues, however, that this factor should still weigh against Owens because the dates were not enforced, but Owens credibly testified that he wanted to work with Lohrey and allow him time to improve his financial situation. In Bishop v. Commissioner, T.C. Memo. 2013-98, at *15, we had a similar situation: The taxpayer did not exercise the acceleration clause under the note when the debtor stopped making payments because he thought that by giving the debtor a chance to recover from the real-estate crisis, the debtor would be able to resume payments. We found this explanation reasonable then, and we find it reasonable now. This factor will weigh in favor of Owens.

The IRS argued that the only possible source of repayment of the debt was earnings, and that a participation in earnings is what makes something equity—so these interests should be treated as equity, not debt. But the Court did not agree, noting:

> The Commissioner argues that because Lohrey Investments would be able to repay its debt to Owens only if Lohrey was able to improve West Coast Linen's financial status, repayment was dependent on earnings. But this isn't how we use this factor. If it were, there could only be investments in, and no lending to, distressed borrowers. This just isn't the rule. We recognize that there are types of debt that look very similar to equity and types of equity that look very similar to debt, but Owens was not close to this line here. His advance of money to Lohrey Investments did have the goal of enabling that business to become profitable enough to repay its lenders, but the repayment of those advances was not legally contingent on success. See *Flint Indus., Inc. v. Commissioner,* T.C. Memo. 2001-276, 2001 WL 1195725, at *12 ("When circumstances make it impossible to estimate when an advance will be repaid because repayment is contingent upon future profits or repayment is subject to a condition precedent, or where a condition may terminate or suspend the obligation to repay, an equity investment is indicated." (quoting *Affiliated Research, Inc. v. United States*, 173 Ct. Cl. 338 [(1965))). As a practical matter, Owens's ability to be repaid would be harmed if Lohrey Investments and West Coast Linen failed, but as a legal matter Owens's advances were secured by a deed of trust on the Gilroy property, and Lohrey Investments was obliged to pay back the advances plus interest. This may be distressed debt, but it is debt nonetheless.

Mr. Owens had received an ownership interest in the entity at one point during this transaction after it was clear the borrower was in financial trouble. The IRS argued that the fact he obtained this interest at a point where the business was in a crisis converted his prior advances to equity and that the same treatment would apply to any subsequent advances. But the Court noted that the operating agreement specifically provided that Mr. Owen's loans will not be treated as a capital contribution and the granting of the interest was not in close proximity to advances—his interest

was received more than a year after his last previous advance, and he did not loan more funds to the entity for two more years. The Tax Court found that there was not a sufficient direct correlation between the grant of the interest and the advances to covert the loans to equity.

Equity holders get paid after creditors, so the fact that Mr. Owens subordinated his debt to that of a new lender might indicate he was an equity holder rather than a creditor. The Tax Court, while noting that the subordination factor does favor the IRS view, finds it's not a determinative factor, nothing that "[w]ithout additional financing from Vestin, Owens would not have seen a return."

But the IRS argues this subordination raises another issue—didn't it indicate that the borrower was unable to obtain loans from outside lending institutions and, therefore, Mr. Owens advance was not in the nature of a loan. But the Court found that the IRS wasn't applying this factor correctly in this case, noting:

> The Commissioner mistakenly hinges his argument on Owens's subordination to Vestin, arguing again that this is not how a reasonable creditor behaves. What this factor requires us to look at, however, is whether at the time Owens made advances to Lohrey Investments, Lohrey Investments could have obtained financing from a different source on the same terms. See, e.g., *Provost v. Commissioner*, T.C. Memo. 2000-177. When Lohrey initially approached OFG it was because other lenders considered financing Lohrey Investments too risky. Yet, OFG — certainly a [*39] legitimate lender — did provide financing. Owens provided more. Later, Lohrey Investments was able to obtain still more debt financing from other sources: There was Vestin, for one, as well as lenders like Podium, Wells Fargo Bank, and Tri-State. These facts bolster a finding that the advances were bona fide debt.

The Court also looked at whether the borrower was so thinly capitalized that the "loans" had to be equity, finding:

> But more cases say that thin capitalization is a strong indication of equity only if (1) the debt to equity ratio was initially high, (2) the parties realized that it would likely go higher, and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations. *Am. Offshore, Inc. v. Commissioner*, 97 T.C. at 604. When Owens made his first loans to Lohrey Investments, they were adequately secured. Subsequent loans might not have been, but those were meant to protect Owens's initial advances, and we don't find they thereby became an equity investment. We also find based on credible testimony that neither Owens nor Lohrey had any reason to believe Lohrey Investments would eventually take on so much additional debt. Both Owens and Lohrey gave credible testimony regarding their optimism about the market — and the Great Recession caught many off guard. We do acknowledge that it is not clear from the record what Lohrey Investments used Owens's initial advances for. We know that at least part of Owens's initial advance was used to pay off another loan. But Lohrey did use subsequent advances to hire additional employees and purchase additional equipment and vehicles to meet the requirements of the highly anticipated Kaiser contract.

All that remained for the taxpayer is to show that the debt became worthless in 2008. The IRS argued that it was not yet worthless in 2008 since the <u>borrower</u> believed in 2008 that his equipment

and property were worth more than the outstanding loans. But the IRS offered no evidence that the borrower's belief was a correct belief. As the Court noted:

> We can think of no reason why we would give Lohrey's subjective belief at the time more merit than the facts and circumstances surrounding Owens's belief that the value of the property was "very small relative to the debt." In fact, we can take into consideration subsequent events to prove the reasonableness of this belief. *Am. Offshore, Inc. v. Commissioner*, 97 T.C. at 597. And Owens indeed did not recover in the bankruptcies: Lohrey Investments' liabilities towered over what the Gilroy Property, water rights, and equipment sold for. Owens recovered nothing.

One factor that could have proved a problem for Mr. Owens was the fact that he had filed a proof of claim in the borrower's bankruptcy. The Court noted that filing a claim "may indicate that a taxpayer had some hope for recovery" the Court was "reluctant to determine the outcome of this case based on Owens's steps to secure his place in the order of distribution." As a practical matter, the Court is saying that this could very well have been an impediment to the deduction, but the Court was willing to overlook this problem based on the other facts that the taxpayer had brought forward.

In the end, the Tax Court allowed Mr. Owens a full deduction for the bad debt in 2008 and allowed him to treat it as a business bad debt, leading to a significant net operating loss.

SECTION: 170
PROCEEDS FROM SALE OF LAND USED FOR FARMING IS NOT INCOME FROM FARMING OR RANCHING FOR PURPOSE OF EXPANDED CONSERVATION EASEMENT DEDUCTION

Citation: Rutkoske, Sr. et al v. Commissioner, 149 TC No. 6, 8/7/17

In the case of *Rutkoske, Sr. et al v. Commissioner*, 149 TC No. 6, the Tax Court was asked to consider what types of income counted as "gross income from the trade or business of farming" for purposes of gaining access to the increased deduction for qualified conservation easements of property used in agriculture or livestock production under IRC §170(b)(1)(E)(iv).

Normally a deduction for a qualified conservation easement is limited to 50% of the taxpayer's income after reduction for other charitable contributions.[3] However, that limit rise to 100% for the contribution of property used in agriculture or livestock production by a qualified farmer or rancher.[4]

To be a "qualified farmer or rancher" under this provision, the taxpayer's gross income from the trade or business of farming must exceed 50% of the taxpayer's gross income for the taxable year.[5] What constitutes the trade or business of farming for this purpose is defined at IRC §2032A(e)(5).[6]

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[3] IRC §170(b)(1)(E)(i)
[4] IRC §170(b)(1)(E)(iv)
[5] IRC §170(b)(1)(E)(v)
[6] IRC §170(b)(1)(E)(v)

In this case the taxpayers engaged in a bargain sale of land that included a grant of conservation easement. As the Court explains the transactions:

> *On June 5, 2009, Browning Creek conveyed a conservation easement to Eastern Shore Land Conservancy, Inc.,4 restricting the development rights attached to the property in exchange for $1,504,960. In connection with the granting of the easement, Browning Creek obtained an appraisal which set forth the fair market value of the unencumbered property as of June 5, 2009, as $4,970,000 and the fair market value of the property after the granting of the conservation easement as $2,130,000. After conveying the conservation easement, later on June 5, 2009, Browning Creek sold its interest in the property to Quiet Acre Farm, Inc. (Quiet Acre), for $1,995,040.*
>
> *Browning Creek reported that its total basis in the property was $1,745,885. Browning Creek allocated $240,828 of this amount to the conservation easement and $1,505,057 to its remaining interest in the property. Browning Creek reported a capital gain of $1,754,115 from the sale of the property: $1,264,132 from the sale of the conservation easement, and $489,983 from the sale of its remaining property interest. Browning Creek also reported a noncash charitable contribution for the conservation easement of $1,335,040 — the difference between the purported value of the property before the conveyance of the conservation easement, i.e., $4,970,000, and the purported value of the property after the conveyance of the easement, i.e., $2,130,000, minus the $1,504,960 Browning Creek received from the sale of the conservation easement.*

The taxpayers asserted that the income derived from the sale of the conservation easement counts as income from the trade or business of farming or ranching, while the IRS argued that such amounts are not part of gross income from that activity.

IRC §2032A(e)(5)'s definition of farming and ranching contains a list of various activities that give rise to income from the trade or business of farming. The activities are:

> (*A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;*
>
> *(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and*
>
> *(C) (i) the planting, cultivating, caring for, or cutting of trees, or*
>
> *(ii) the preparation (other than milling) of trees for market.*

The taxpayers argue the sales proceeds should be included based on the following rationale:

> *Petitioners maintain that the business of farming requires monetary capital and investment in tangible physical capital, including land, buildings and structures, and machinery and equipment. Hence they posit:*
>
> > *proceeds from a sale of an asset used in the business of farming constitute income from the business of farming. Accordingly, the proceeds of sale of a tractor used in the business of*

> *farming would be characterized as income from the business of farming. Proceeds from a sale of real estate used in the business of farming likewise generates income from the business of farming.*

> *Petitioners argue that the sale of the property falls under the strictures of section 2032A(e)(5) in that "farm real estate is an asset integral to raising, harvesting and/or producing saleable agricultural or horticultural commodities as well as the handling, drying, packing, grading, and or storing the agricultural and/or horticultural commodities produced for sale." Thus petitioners assert that proceeds from the sale of real estate used in the business of farming generates income from the trade of business of farming.*

The IRS, on the other hand, argue that to qualify for the special 100% rate, the income must come exclusively from the listed activities and can't be "expanded" to include other income that does not represent the specifically enumerated activities.

The Tax Court sided with the IRS in this case. The Court held:

> *We do not agree with petitioners' assertion that the disposal of property (and the development rights attached thereto) constitutes cultivating the soil, raising agricultural or horticultural commodities, the handling of such commodities, or tree farming. To cultivate means "[t]o prepare and improve (land), as by fertilizing or plowing, for raising crops". Webster's II New Riverside University Dictionary 335 (1988); to "raise" in the context of agriculture means "[t]o grow or breed"; id. at 972; and to "harvest" means "[t]he act or process of gathering a crop"; id. at 566. For the contribution of the conservation easement to qualify for the special rule of section 170(b)(1)(E)(iv), we look to the income derived from the sale of the agricultural and/or horticultural products created when engaging in these activities, not from the sale of the land on which the agricultural and/or horticultural products are grown.*

Of course, if such sales do not count as part of the farming income, then this additional "abnormal" income could easily serve to disqualify an otherwise qualified farmer solely for that year of sale. The opinion recognizes that but notes:

> *We recognize that the statute makes it difficult for a farmer to receive a maximum charitable contribution deduction by disposing of a portion of property in a year in which he/she donates a conservation easement, especially in a State with high land values. But it is not our task to rewrite a statute.*

Or, to put more simply, if this is a problem it is one that Congress must solve.

SECTION: 1031
BENEFITS AND BURDENS TEST DOES NOT APPLY IN CASE OF REVERSE §1031 EXCHANGE, BUT IRS ANNOUNCES WILL NOT ACQUIESCE

Citation: Estate of George H. Bartell Jr. et al. v. Commissioner, 147 TC No. 5 , 8/10/16, AOD 2017-006, 8/14/17

The IRS has announced that it will not acquiesce with regard to a Tax Court decision that dealt with reverse like-kind exchanges under Section 1031 in Action on Decision AOD 2017-06.

Since its original enactment, the like kind exchange provisions IRC §1031 has been allowed to apply to transactions for which there is not a direct exchange between parties of property. Initially such transactions were expanded, first by judicial holdings and then explicitly by Congress [IRC §1031(a)(3)] to include deferred "forward" exchanges where the taxpayer does not simultaneously receive the replacement property from the party that acquires the relinquished property, but rather, with the use a qualified intermediary, acquires property from another party with the proceeds of the sale.

Later case law allowed for reverse deferred exchanges (referred to as reverse *Starker* exchanges in reference to a major Ninth Circuit case on the original forward exchanges) where the replacement property is acquired first and then the relinquished property is later sold.

While we have law and regulations implementing forward exchanges, there was nothing equivalent for reverse exchanges—they were judged on a facts and circumstances basis. In 2000 the IRS finally issued safe harbor guidance for reverse exchanges in Revenue Procedure 2000-37. That imposed certain requirements to obtain safe harbor treatment for a reverse exchange that were similar to those imposed on a forward exchange.

However this is merely a safe harbor and, as the IRS noted in the Revenue Procedure:

> …[T]he Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.

In the case of *Estate of George H. Bartell Jr. et al. v. Commissioner*, 147 TC No. 5 the Tax Court was asked to look at a reverse exchange case that did not meet the safe harbor tests in Revenue Procedure 2000-37 and which the IRS was arguing failed to qualify for §1031 deferral.[7]

In this case the taxpayer had entered into an agreement to acquire property in Lynnwood in 2000, with title held by the facilitator under an agreement that would allow the taxpayer to manage construction on the property and lease the property once construction was finished in order to operate a drug store in the property. The taxpayer intended from the outside to enter into a §1031 exchange transaction. Due to various developments, the sale of the relinquished property did not close until December of 2001, well outside the time frame allowed in the safe harbor under Revenue Procedure 2000-37 and the identical time periods for a forward exchange. In the interim, construction had been completed and Bartell Drug had begun operating its drug store in the Lynnwood location.

The key question before the Court was whether the S corporation which reported the exchanges had actually been the true owner of the replacement property prior to the sale of the relinquished

[7] The transaction actually began before the publication of Revenue Procedure 2000-37, so that procedure would not apply by its own terms. But the transaction was "out of compliance" with its standards so its availability would not appear to have had any impact on this case—thus the case should still be relevant to transactions taking place today that simply don't meet the requirements.

property. If the corporation (Bartell Drug Co.) was actually the owner of the replacement property prior to sale of the relinquished property it would be exchanging property with itself—not a transaction that would qualify for §1031 gain deferral.

The IRS argued that a "benefits and burdens" test, used often in many contexts under the IRC, should determine if Bartell Drug was the true owner of the property. The IRS notes:

> …Bartell Drug already owned the Lynnwood property at the time of the disputed exchange because Bartell Drug—not EPC Two—had all the benefits and burdens of ownership of the property; namely, the capacity to benefit from any appreciation in the property's value, the risk of loss from any diminution in its value, and the other burdens of ownership such as taxes and liabilities arising from the property. By contrast, respondent contends, EPC Two did not possess any of the benefits and burdens of ownership of the property; it had no equity interest in the property, it had made no economic outlay to acquire it, it was not at risk with respect to the property because all the financing was nonrecourse as to it, it paid no real estate taxes, and the construction of improvements on the property was financed and directed by Bartell Drug. Moreover, respondent contends, Bartell Drug had possession and control of the property during the entire period EPC Two held title, first by virtue of the REAECA provisions giving it control over the construction of site improvements and then possession through a lease that EPC Two was obligated under the REAECA to extend to it, for rent equal to the debt service on the KeyBank loan plus EPC Two's fee for holding title.

In fact, the position that Bartell was in would generally have met the "benefits and burdens" test in other contexts—but the taxpayer argued that the "benefits and burden" test is not relevant in the context of a reverse §1031 exchange.

> Petitioners point out, however, that both this Court and the Court of Appeals for the Ninth Circuit, to which an appeal in this case would ordinarily lie, see sec. 7482(b), have expressly rejected the proposition that a person who takes title to the replacement property for the purpose of effecting a section 1031 exchange must assume the benefits and burdens of ownership in that property to satisfy the exchange requirement. As the Court of Appeals for the Ninth Circuit pointed out in *Alderson v. Commissioner*, 317 F.2d at 795:
>
>> [O]ne need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title solely for the purpose of exchange and accept title and transfer it in exchange for other like property, all as a part of the same transaction with no resulting gain which is recognizable under Section 1002 of the Internal Revenue Code of 1954.

As the Court continues:

> When the third-party exchange facilitator has been contractually excluded from beneficial ownership pursuant to the agreement under which he holds title to the replacement property for the taxpayer, that beneficial ownership necessarily resides with the taxpayer once title has been obtained from the seller of the replacement property. And yet the third-party exchange facilitator, rather than the taxpayer, has been treated as the owner of the replacement

> property at the time of the exchange in the cases cited above. Otherwise, a disqualifying self-exchange could be said to have occurred.

The opinion goes on to note that this is one of those rare cases in the IRC where form controls over substance—that is, in a traditional forward exchange there's not any real economically substantial difference between the exchange with a facilitator and the sale of property by the taxpayer who then takes the proceeds and a few days later buys replacement property. But the tax difference is significant, all because of the form of the transaction.

The Court goes on to note that the Courts have granted great latitude to taxpayers in having transactions qualify for like kind treatment.

The IRS argued that the Tax Court had, in fact, endorsed the "benefits and burdens" test for reverse exchanges in the case of *DeCleene v. Commissioner*, 115 T.C. No. 34 when it found the transaction in question failed to qualify. But the Tax Court distinguished that case, holding the facts there were unique:

> Given the *DeCleene* Opinion's explicit and repeated emphasis upon the taxpayer's failure to use a third-party exchange facilitator, it must be said that *DeCleene* did not address the circumstances where a third-party exchange facilitator is used from the outset in a reverse exchange. Moreover, the taxpayer in *DeCleene* had acquired the purported replacement property outright, and held title to it directly without any title-holding intermediary, for more than a year before transferring title to WLC. This feature also distinguishes *DeCleene* from the myriad of cases where taxpayers seeking section 1031 treatment were careful to interpose a title-holding intermediary between themselves and outright ownership of the replacement property. In sum, *DeCleene* does not dictate a result for respondent here.

The Tax Court then goes on to note:

> *Alderson* and *Biggs* establish that where a section 1031 exchange is contemplated from the outset and a third-party exchange facilitator, rather than the taxpayer, takes title to the replacement property before the exchange, the exchange facilitator need not assume the benefits and burdens of ownership of the replacement property in order to be treated as its owner for section 1031 purposes before the exchange.

The Court also rejected the IRS's objection that those cases shouldn't apply because they involved forward exchanges and this is a reverse exchange. The Court pointed out that by the IRS's own definition the transaction in *Biggs* was a reverse exchange, even if had features that lead some to refer to as a forward exchange case. In any event, the Court noted that the specific question before the court (ownership of property) has application to forward exchanges, stating:

> …[E]ven forward exchange cases, including *Alderson* and those that permit "great latitude" to taxpayers in structuring section 1031 transactions, *Starker*, 602 F.2d at 1353 n.10, analyze the relationship to the replacement property of the taxpayer versus the third-party exchange facilitator, and treat the latter as the owner before the exchange, typically notwithstanding the utterly "transitory", *Barker v. Commissioner*, 74 T.C. at 565, and nominal nature of that ownership. In our view, this analysis of the relationship of the taxpayer to the replacement

> property, as compared to an exchange facilitator holding bare legal title, is equally applicable in a reverse exchange, as the holding in *Biggs* confirms. See also *DeGroot v. Exchanged Titles* (*In re Exchanged Titles, Inc.*), 159 B.R. 303 (Bankr. C.D. Cal. 1993) ("[T]he transfer of legal title is sufficient to effectuate a reverse I.R.C. § 1031 exchange involving an accommodator[.]").

The Court found that the analysis applied even though the accommodator was obligated to and did lease the property to Bartell Drug and that the time span in question was significantly longer than the time periods in the cases cited above.

The Court notes:

> Given the inapplicability of Rev. Proc. 2000-37, supra, to the transaction at issue, the caselaw provides no specific limit on the period in which a third-party exchange facilitator may hold title to the replacement property before the titles to the relinquished and replacement properties are transferred in a reverse exchange. We express no opinion with respect to the applicability of section 1031 to a reverse exchange transaction that extends beyond the period at issue in these cases. In view of the finite periods in which the exchange facilitator in these cases could have held, and in fact did hold, title to the replacement property, we are satisfied that the transaction qualifies for section 1031 treatment under existing caselaw principles.

Although the Court notes that it is limiting the application of this holding to the facts before it here, the Revenue Procedure in question is merely a safe harbor and, in its text, grants that structures other than those found in the safe harbor may qualify for deferral in a reverse exchange context.

Advisers still should likely advise taxpayers that, if at all possible, a reverse exchange should be structured to comply with the requirements of the Revenue Procedure to avoid any question regarding the status of the gain. But if things don't go quite as expected and the transaction no longer fits within the requirements for the safe harbor this case raises the possibility that a gain deferral may still be possible—but the taxpayer needs to be aware that the IRS may very well challenge that treatment.

SECTION: 6109
MINORITY SHAREHOLDER SUBJECT TO TRANSFEREE LIABILITY REPAYMENT EVEN THOUGH NOT AWARE OF FRAUDULENT NATURE OF PAYMENTS

Citation: Kardash, Sr. v. Commissioner, Case No. 16-14254, CA11, 8/4/17

The Eleventh Circuit panel hearing the appeal in the case of *Kardash, Sr. v. Commissioner*, Case No. 16-14254, CA11 agreed that Mr. Kardash was not a villain and, in many ways, was a victim along with the IRS of a "the fraud conducted by his friends and coworkers at FECP, Ralph Hughes and John Stanton."

But the Court found that, ultimately, Mr. Kardash ended up with funds that rightly belonged to the IRS and that IRC §6109, relying on applicable Florida state law, required him to pay those funds over to the IRS under the law of transferee liability.

Mr. Kardash was a minority shareholder and employee of Florida Engineered Construction Products Corporation ("FECP"), a company involved in manufacturing items used in construction, an activity it had been involved in since 1955. Mr. Kardash joined the company in 1979 and eventually became a minority shareholder and President of manufacturing and operations.

Mr. Kardash owned 575,000 shares of FECP stock. The other shares were held by Ralph Hughes (3,000,000), John Stanton (3,000,000) and Charles Robb (75,000). Actual control rested with Mr. Hughes and Mr. Stanton.

FECP's activities in the first decade of the 2000s is described as follows in the opinion:

> *During the early 2000s, FECP's revenues rose dramatically with the booming housing market. In 1999, FECP earned $39.9 million in revenue, but by 2005, FECP's revenues had risen to $132.2 million. Unfortunately for FECP, however, 2005 represented the high-water mark for the company. By 2007, the housing bubble in Florida had already begun to burst, and FECP's revenues shrank to $55.4 million.*
>
> *Throughout this period, FECP paid no federal income tax and its majority shareholders, Hughes and Stanton, siphoned substantially all of the cash out of the company.2 The two are believed to have used hidden bank accounts and shell corporations to facilitate their fraud undetected. At no point was Kardash, who focused on managing FECP's production operations, involved in the cash-siphoning scheme.*

Eventually, not being paid taxes, the IRS showed up and determined that FECP owed the IRS $129,130,131.60. The IRS agreed to an installment agreement with FECP to be paid $70,000 a month, a payment that would not pay off the company's debt for over 150 years. The IRS also began pursing funds that had been transferred to the shareholders.

As the Court noted, the IRS had success here:

> *Stanton and Hughes, the majority-shareholder masterminds of the cash-siphoning scheme, were easy targets. Stanton was ultimately convicted on eight counts of federal tax crimes and, per the terms of his sentencing order, required to pay restitution. The Commissioner likewise reached an agreement with the estate of Hughes, who had passed away in 2008. Robb and Kardash, however, contested the Commissioner's determination of liability in the tax court below, arguing that they were not liable as transferees for FECP's outstanding tax liability. Only Kardash's transfers are the subject of this appeal.*

The IRS initially was after two sets of payments to Mr. Kardash:

- Advance Transfers of $250,000 and $300,000 in 2003 and 2004 and
- Dividend Payments of $1.5 million, $1.9 million, and $57,500 in 2005, 2006 and 2007.

Mr. Kardash argued that these payments were made to him to compensate him for the loss of the lucrative bonuses he had previously received, thus represented transfers from the company to him for his services.

The Tax Court agreed that the advance transfers were meant to replace the bonuses, and thus did not represent fraudulent transfer which the IRS could recover from Mr. Kardash. However, the Court found the dividends, begin labeled such by the corporation and treated as such by Mr. Kardash on his tax return (where he treated as qualified dividends subject to a lower tax rate), were not received in exchange for anything of value—and thus were fraudulent conveyances under Florida law which the IRS could recover from Mr. Kardash under IRC §6109.

Mr. Kardash argued that the IRS had not first exhausted all reasonable efforts to collect from FECP before pursuing him and, in any event, the entity did not become insolvent until 2006 so the payments before that date could not be part of a fraudulent conveyance.

The appellate panel noted that IRC §6109 was meant to simplify the IRS's ability to collect from transferees without having to enter into complicated state litigation—but it only applied if the IRS had such rights already. The provision allows the IRS to directly collect amounts for which it had a right either in equity or under law against a third-party transferor.

The panel agreed that for the IRS to proceed in equity they would have to show both that the transferor was, or was rendered, insolvent by the transfer and that the IRS had exhausted all remedies against FECP before it went after Mr. Kardash. But, the panel continued, the state of Florida had enacted the Florida Uniform Fraudulent Transfers Act and, under that law, an exhaustion of remedies against the original debtor is not required for the creditor to move against a party receiving a fraudulent conveyance.

So, the question arose, were some or all of the dividend transfers fraudulent conveyances under Florida law? The appellate court agreed with the Tax Court's holding that the dividends were not shown to be for Mr. Kardash's services, thus he could not avail himself of the protection that the dividend transfers from the corporation were for value.

But, Mr. Kardash argued, since the corporation did not become insolvent until 2006, the 2005 dividend did not represent a fraudulent conveyance. However, the panel agreed with the Tax Court's view that the dividend program was part of an intentional plan to drain the corporation of assets and that Mr. Kardash's share of that transfer met the requirements for a fraudulent conveyance even if he was not aware of the plan in question.

As the panel notes:

> *Although Kardash was not privy to the machinations of Stanton and Hughes, his 2005 dividend payment was part of the same series of dividend payments that led to FECP's insolvency. Kardash, Hughes, and Stanton were all paid dividends based upon their equity ownership in the company. The record does not reflect, for example, that FECP issued different classes of shares and that Stanton and Hughes perpetrated their fraud by triggering special dividends that were distributed solely to their class of shares. On the contrary, the record suggests that the dividends were paid on a per-share basis and that any discrepancy in the amounts paid to Kardash, Hughes, and Stanton can largely be attributed to the different number of shares that they owned.*

Thus, the IRS had the right to recover from Mr. Kardash all the dividend payments he received for all three years.