Estate of George Bartell, Jr. et al. v. C.I.R.
147 T.C. No. 5 (2016)

In this Tax Court decision, a 17 month reverse construction exchange using an exchange facilitator (EF) was found to be valid. The Court found that the EF was not required to bear the benefits and burdens of ownership of the property. Instead, an agency test applied, and the exchange was valid because the EF was not the TP's agent.

Bartell Drug Co. (BD) and an exchange facilitator, EPC Two LLC (EPC), entered into a reverse exchange agreement (the "Agreement"). EPC was a sole purpose entity formed for this exchange, and was to be paid a fee of 0.5% of value of land and improvements. Under the Agreement, EPC acquired title to the replacement property land in the exchange and a drugstore was to be constructed on the land. The acquisition and construction were funded by a loan from a bank that was non-recourse to EPC and guaranteed by BD. BD also lent EPC a portion of funds for the construction, and this loan bore no interest for the first 180 days, and thereafter bore interest at 7% per annum. EPC entered into the construction contract with the contractor, but BD managed the construction and approved all draws under the loan. BD had the right to purchase the property for EPC's costs for a period of 24 months. EPC was indemnified by BD for general and environmental liabilities. The building permits were issued in the name of BD, and BD represented to the City issuing the permits that it held beneficial title to the property.

When the construction was completed, EPC, as landlord, and BD, as tenant, entered a net lease for the property. The net rent was set at $2,000.00 per month, but the total payments to EPC, including the rent, were capped at the fee set at 0.5% of the total value of the replacement property. BD, as tenant, was responsible for paying EPC's debt payments to the bank, as well as all utilities, taxes and insurance.

The exchange occurred 17 months after EPC acquired the replacement property. At the time of the exchange, BD substituted a new relinquished property for the relinquished property initially identified in the Agreement. The exchange occurred through the use of a QI in the usual manner.

The Court stated that the outcome depended on who owned the replacement property for the purposes of Section 1031 at the time of the exchange. This, in turn, depended on whether the correct test for ownership was: (1) who had the benefits and burdens of ownership of the replacement property, as the IRS argued, or (2) whether EPC was BD's agent in holding title to the replacement property, as BD argued. The Court agreed with BD because the caselaw supported the notion that the exchange facilitator need not have the benefits and burdens of ownership, relying on *Biggs v. Commissioner,* 69 TC 905 (1978), aff'd 632 F.2d 1171. The Court also relied on *Alderson v. Commissioner,* 317 F.2d 790 (9th Cir. 1963), rev'g 38 T.C. 215 (1962), which expressly rejected the contention that the party holding legal title to the replacement property at the time of the exchange with the taxpayer must possess the benefits and burdens of ownership. The Court pointed out that *Alderson* is a Ninth Circuit case and an appeal in this case will lie in the Ninth Circuit.

The Court rejected the IRS's reliance on *DeCleene v. Commissioner*, 115 T.C. 457 (2000) because *DeCleene* did not address the circumstances where a third-party exchange facilitator is used from the outset in a reverse exchange. The IRS also argued that *Biggs* and *Alderson* only applied to forward exchanges, but the Court held the principles are equally applicable in a reverse exchange. The Court additionally found that the six month lease period of the replacement property to the taxpayer prior to the exchange did not affect the result. Finally, the Court expressly did not express an opinion on a reverse exchange transaction that extends beyond the 24 month period at issue in this case.