

December 2010: PLR 201048025 Non-Tax Avoidance Exception to 1031(f)(4) Applies when Related Parties are also Exchanging

In this private letter ruling, the IRS approved successive exchanges by taxpayers into replacement properties owned by related parties, provided each related party will hold its replacement property for at least two years following acquisition of the property.

The Taxpayer and the related party (Related Party) are both REITs. In exchange #1, the Taxpayer had previously sold the relinquished property to the buyer (using a QI) and identified replacement property owned by Related Party. At the time of the ruling, the taxpayer is going to proceed to acquire all of its replacement property from the Related Party, and the Taxpayer will hold those properties for at least two years following acquisition of the properties.

The Taxpayer's replacement property in exchange #1 will then become the Related Party's relinquished property in exchange #2. The Related Party will use a QI in exchange #2, and will identify replacement properties which may include properties owned by the Taxpayer or other related affiliates of the Related Party and the Taxpayer (each an "Affiliate"). If the Related Party reinvests less than 100% of the value of its relinquished properties, the Related Party will recognize gain in the amount of the difference. The amount of the recognized gain will not exceed an unspecified percentage of the realized gain. The Related Party will hold its replacement properties for at least two years following the date of acquisition of the properties.

The Related Party's replacement properties in exchange #2 will become the respective Affiliates' relinquished properties in exchange #3. An Affiliate will identify and acquire replacement properties from unrelated parties. If an Affiliate reinvests less than 100% of the value of its relinquished properties, the Affiliate will recognize gain in the amount of the difference. The amount of the recognized gain will not exceed an unspecified percentage of the realized gain. The Affiliate will hold its replacement properties for at least two years following the date of acquisition of the properties.

The ruling holds that the exchanges contemplated do not run afoul of Section 1031(f) because all the related parties are acquiring replacement properties in nonrecognition transactions and holding their replacement properties for at least two years following their respective acquisitions of replacement property. There is no material "cashing out" of any party's investment in real estate. Further, the *de minimis* amount of boot received does not cause the Section 1031(f) to apply.

In another interesting aspect of the ruling, the buyer in exchange #1 buyer received a credit against the purchase price for unamortized prepaid rent. The ruling states that the submission treats the prepaid rent as a liability assumed by the buyer under Reg. 1.467-7(e)(2)(iii). The ruling also states that the gross sales price of the relinquished property, not reduced for exchange expenses and closing costs, was used in computing the 200% identification rule. The regulations themselves only state the "fair market value" of the relinquished property is used, and they do not address if expenses affect the 200% rule. Presumably, receipt of other cash boot would not reduce the 200% calculation either.