July–August 2011

Like-Kind Exchange Corner

By Mary B. Foster

Escaping Code Sec. 1031 in Order To Deduct a Loss

Many real estate assets are being disposed of at a tax loss due to the downturn in the market. If a disposition is part of an exchange under Code Sec. 1031, the taxpayer will be unable to recognize the loss because the nonrecognition provisions of Code Sec. 1031 are mandatory and apply to losses as well as gains.[1] A taxpayer can easily avoid Code Sec. 1031 treatment when the taxpayer has a cash sale for the relinquished property. The taxpayer simply sells the property and independently reinvests the proceeds in another property. But in some transactions, the transfer of the relinquished property may be all or part of the consideration for the replacement property. In such a case, the mandatory exchange treatment may be difficult or even impossible to escape. This article examines the authorities in this area and looks at how Code Sec. 1031 can possibly be avoided.

Unwanted Nonrecognition of Loss

Sometimes a cash sale is not available or would not make the best economic sense, so the taxpayer swaps properties with the buyer of the taxpayer's property. For example, in *Godine*,[2] the taxpayers wanted to dispose of their apartment building, which needed repairs and had become a losing venture. They had no funds to purchase a new property, so they agreed to swap the apartment building for a duplex that was owned by their real estate agent. They did not consider the effects of Code Sec. 1031 on the swap and deducted the tax loss from the disposition of the apartment building. When the IRS disallowed the

Mary B. Foster is President of 1031 Services Inc. in Bellevue, Washington.

loss, the taxpayers argued that they did not intend an exchange. However, the court sided with the IRS in disallowing the loss deduction, and stating that Code Sec. 1031 cuts both ways, in that neither gains nor losses are recognized in tax-free exchanges.

Some taxpayers find themselves in an exchange situation like the Godines, swapping properties with the buyer and unintentionally falling into Code Sec. 1031.

> **Example.** Suppose Tom wants to exchange Property A with an adjusted basis of $3 million and a value of $2 million for like-kind Property B owned by Betty. Property B has a value of $1.5 million, so Tom also will receive cash of $500,000 to make up the difference in values. If Tom could simply sell Property A for $2 million, Tom would recognize a $1 million loss. Then Tom could then take the proceeds and purchase Property B from Betty for $1.5 million in an unrelated transaction. However, if Tom swaps Property A with Betty for Property B, the transaction will fall under Code Sec 1031. Tom will have an adjusted basis in Property B of $3 million less the $500,000 of cash received by Tom, or $2.5 million. Tom's $1 million loss would not be recognized until he later disposed of Property B in a taxable transfer.

Treasury Authorities

The regulations to Code Sec. 1031 provide that if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.[3] Thus, in our example, it would seem that Tom can avoid exchange treatment by first receiving funds in the full amount of the purchase price from Betty, and then purchasing the replacement property from Betty with these funds.

> [T]he IRS indicated that an exchange may be found in circumstances involving a sale of equipment to a dealer and a purchase of equipment from the dealer when the sale and purchase are "reciprocal and mutually dependent."

However, in Rev. Rul. 61-119,[4] the IRS indicated that an exchange may be found in circumstances involving a sale of equipment to a dealer and a purchase of equipment from the dealer when the sale and purchase are "reciprocal and mutually dependent." This is true "even though the sale and purchase are accomplished by separately executed contacts and treated as unrelated transactions by the taxpayer and the dealer for record purposes."

Thus, in our example above, Tom's receipt of cash may not be sufficient to escape Code Sec. 1031 if the sale and purchase are reciprocal. Further, Betty may not have sufficient cash to pay to Tom, and third-party financing may not be available either. In addition, if Betty did have funds available, she would likely condition any advance to Tom upon Tom's immediate purchase of the replacement property from Betty. This condition could cause the sale and purchase to be reciprocal and mutually dependent.

Case Law

Rev. Rul. 61-119 has been discussed in three cases involving truck transactions. These cases offer some guidance on how to avoid an exchange of properties under Code Sec. 1031.

Redwing Carriers, Inc.

In the earliest case, *Redwing Carriers, Inc.*,[5] the taxpayer was a trucking company and the taxpayer's related corporation was a used truck dealer. In a series of transactions, the related corporation would first purchase new trucks from the manufacturer for cash, with the intent of selling the new trucks to the taxpayer. The taxpayer then would sell the used trucks to the manufacturer and purchase the new trucks from the related corporation. The manufacturer viewed the transactions as interdependent and would not purchase a used truck from the taxpayer without the sale of a new truck to the related corporation. Further, the purchase price of the used trucks was above fair-market value so that the manufacturer did not recognize a profit from the acquisition without taking into consideration the purchase of the new trucks by the related corporation. Favorable capital gains rates were available for personal property prior to 1962, and the taxpayer wanted to claim these rates on the sale of the used trucks, while acquiring the new trucks with a high basis for depreciation purposes.

The court found that the sales and purchases were contractually interdependent and, therefore, the substance of the transactions was an exchange. There would have been no purchases of the new trucks without the concurrent binding agreement to sell the used trucks. The court further stated that an exchange could not be transformed into two sales by the arbitrary separation of time and the insertion of cash, and the court ignored the fact that the replacement trucks were first acquired by the related corporation, calling this an "intracorporate fictional distinction."

This contractual interdependence test set forth in *Redwing Carriers, Inc.* makes it difficult to structure a two-party swap of properties (or a three-party swap using a related party) without the application of Code Sec. 1031. Using our example, it would require that Betty pay Tom cash, or other non–like-kind consideration, without the condition that Tom acquire Property B from Betty. Applying the test set forth in *Redwing Carriers, Inc*., separating the sale of Property A to Betty from the purchase of Property B by Tom with the use of separate escrows on different days would not be sufficient to avoid a Code Sec. 1031 exchange if the two transactions were conditioned on each other.

Under the holding of *Redwing Carriers, Inc.,* the IRS can use the substance-over-form doctrine to assert that a sale and a purchase constitute an exchange under Code Sec. 1031 in order to deny recognition of the loss, even when a taxpayer clearly did not want exchange treatment and used the proper form of a sale and a purchase. On the other hand, when a taxpayer clearly wants exchange treatment but somehow fails to meet the technical requirements of Code Sec. 1031, the IRS will use the form-over-substance approach to deny the taxpayer the gain deferral.[6] Thus, Code Sec. 1031 appears to elevate form over substance when it comes to disallowing a gain deferral and substance over form when it comes to denying a loss. The taxpayer in *Redwing Carriers, Inc.* raised this inconsistency by pointing out the decision in *Carlton.*[7] In that case, both the taxpayer and the purchaser intended to effect an exchange. The taxpayer attempted to structure a three-party exchange, but received unrestricted cash to purchase the replacement property. Therefore, the exchange was disallowed despite the taxpayer's intentions. The court in *Redwing Carriers, Inc.* distinguished the two cases by noting that the contracts in *Carlton* for the replacement property were with a third party, so they were severable. The transfers in *Redwing Carriers, Inc.,* however, were basically between two parties (the court ignored the insertion of the related corporation) and were contractually interdependent.

Bell Lines, Inc.

In the second case involving a trucking company, the taxpayer again was trying to obtain capital gains from the sale of used trucks while acquiring new replacement trucks from a manufacturer.[8] The taxpayer refused a trade-in with the manufacturer because the taxpayer believed that it would get a better price on the new trucks if no trade-in were involved. The manufacturer, wanting to make the sale of the new trucks, arranged for the taxpayer to sell the relinquished trucks to an unrelated party. The unrelated party paid the taxpayer cash, and the taxpayer then purchased the replacement trucks from the manufacturer. Unbeknownst to the taxpayer, the manufacturer had actually advanced the cash to the third-party buyer and guaranteed the third party that it would not lose money on the used trucks. Further, the manufacturer ended up acquiring the used trucks from the third party. Unlike *Redwing Carriers, Inc.,* the court in *Bell Lines, Inc.* found that Code Sec. 1031 did not apply because the sales of the used trucks and purchases of the new trucks were mutually exclusive, having an independent legal significance and a business purpose. The taxpayer was bound to purchase the new trucks without regard to the sale of the used trucks. Further, the court noted that taxpayer was unaware of the side agreement between the manufacturer and the third-party buyer, but it is not clear how critical this factor was in the court's holding.

C. Bean Lumber Transport, Inc.

In the third trucking company case, the taxpayer wanted exchange treatment for its sales and purchases.[9] The taxpayer would purchase new trucks from a dealer, and would later sell used trucks to the same dealer. The taxpayer obtained 100-percent financing from third-party finance companies for the purchase of the new trucks. The taxpayer then kept the cash from the later sale of the used trucks to the dealer, thereby fully cashing-out. The court found that the purchase of the new trucks and the sales of the old trucks were independent transactions.

Structuring Ideas

Using our example again, suppose that Tom wants to swap Property A with Betty for Property B, and Tom would like to recognize a loss. Betty is willing to structure the swap as two taxable transactions. Based on the trucking company cases and the other authorities, Tom can avoid Code Sec. 1031 treatment by first structuring a separate sale of Property A to Betty. The purchase price for Property A could be paid in cash or a promissory note from Betty. Tom should then purchase Property B from Betty in a separate transaction with separate financing or cash. Or the order can be reversed, with Tom first purchasing Property B from Betty with cash or financing and later selling Property A to her, as in *C. Bean Lumber, Inc.* The purchase should occur on a different day than the sale transaction, although Tom should be mindful of the statement in *Redwing Carriers, Inc.* that "a tax-free exchange cannot be transformed into two sales by the arbitrary separation of time and the insertion of cash." Most importantly, the two transactions must be independent and the purchase should not be conditioned upon the sale and *vice versa*.

These ideas may not be helpful if the parties do not have cash or financing available. Further, because the transactions must be independent, each party must take the risk that the other party will not complete the second transaction. This may not be viable from a business standpoint. As an alternative, Property B could be acquired by Tom's related party rather than by Tom himself. Under Code Sec. 1031, the same taxpayer that sells the relinquished property must acquire the replacement property.[10] Thus, the exchange would fail if Tom did not acquire the replacement property. To avoid a sham-transaction argument by the IRS, however, the related party would need the financial means to acquire Property B, and should not merely be Tom's shell entity. Further, the related party should continue to own and operate Property B. Remember that the court in *Redwing Carriers, Inc.* ignored the insertion of a related party between the taxpayer and the manufacturer as a "fictional distinction" when the related party acquired the replacement trucks with the intent to sell them to the taxpayer.[11]

Conclusion

The current economic downturn, combined with the lack of financing, has raised the issue of how to escape Code Sec. 1031 when two parties want to swap properties, but at least one of the parties still wants to recognize a tax loss. Escaping Code Sec. 1031 may prove difficult if the parties do not have access to cash, or one party does not want to structure the swap as two separate and independent transactions. In such a situation, a related party could acquire the replacement property so that the transactions would fail the same taxpayer requirement of Code Sec. 1031.

Endnotes

1 Code Sec. 1031(a); *G.W. Vardine*, CA-2, 62-2 USTC ¶9624, 305 F2d 60.

2 *J. Godine*, 36 TCM 1595, Dec. 34,739(M), TC Memo 1977-393.

3 Reg. §1.1031(k)-1(f).

4 Rev. Rul. 61-119, 1961-1 CB 395.

5 *Redwing Carriers, Inc.*, CA-5, 68-2 USTC ¶9540, 399 F2d 652.

6 For example, the taxpayer may fail to meet one of the technical requirements of the qualified intermediary safe harbor. *See* TAM 200130001 (Jul. 27, 2001) in which the IRS disallowed an exchange when the taxpayer failed to notify the buyer of the relinquished property of the assignment of the sale contract from the taxpayer to the qualified intermediary.

7 *J.P. Carlton*, CA-5, 67-2 USTC ¶9625, 385 F2d 238.

8 *Bell Lines, Inc.*, CA-5, 73-2 USTC ¶9524, 480 F2d 710.

9 *C. Bean Lumber, Inc.*, DC-AR, 68 FSupp2d 1055 (1999).

10 *D.G. Chase*, 92 TC 874, Dec. 45,634 (1989).

11 Interestingly, the IRS recently issued ILM 201013038, which denied exchange treatment when a related party dealer first acquired the replacement equipment from the manufacturer with the intent to transfer it to the taxpayer in an exchange using a qualified intermediary. The IRS did not find the intervening related party acquisition to be a "fictional distinction" when the taxpayer was attempting to defer gain.