Like-Kind Exchange Corner

By Mary B. Foster

More on Related Parties and Code Sec. 1031(f): IRS Issues Rulings on Exceptions to Related Party Exchange Rules

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The July–August 2007 edition of the JOURNAL OF PASSTHROUGH ENTITIES contained an article titled "*Related Parties and Code Sec. 1031(f): The Do's and Don'ts*", which was updated in the July–August 2009 edition with a discussion of the decision in *Ocmulgee Fields, Inc.*[1] This article provides a further update discussing two new rulings from the IRS that address exceptions to the related-party provisions of Code Sec. 1031(f). Both rulings involve a taxpayer who transfers the relinquished property to an unrelated party in an exchange using a qualified intermediary (QI), and then acquires the replacement property from a related party.[2] As discussed in the earlier articles, this structure will result in a taxable transaction under Code Sec. 1031(f)(4), unless the taxpayer can fall within the "nontax avoidance" exception of Code Sec. 1031(f)(2).

No Exception for Acquisition from Related Dealer

In the first ruling, Chief Counsel Advice 201013038,[3] the taxpayer was an equipment lessor that leased a certain brand of heavy equipment to unrelated customers. The related party was a retail dealer in the same brand of equipment. The taxpayer engaged in a series of equipment exchanges under a master exchange agreement with a QI,[4] and the replacement equipment in the exchanges was acquired from the related-party dealer.

Because the ruling involved a series of equipment exchanges, the IRS analyzed a single deferred exchange of off-road trucks as a representative transaction. The relinquished truck was first sold by the

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taxpayer to an unrelated buyer through the QI, who later used the proceeds of the sale to acquire a new off-road truck from the related-party dealer. This new truck was sold to the taxpayer (through the QI) at the dealer's cost, and thus, the dealer did not recognize any income on the sale.

The IRS first found that the truck exchange fell within Code Sec. 1031(f)(4) and Rev. Rul. 2002-83,[5] as a transaction structured to avoid the purposes of the related-party rules of Code Sec. 1031(f)(1). The IRS reasoned that basis shifting occurred because the related-party dealer sold inventory in the exchange at its cost (realizing no gain while pocketing cash), while the taxpayer attempted to defer its gain from the disposition of the relinquished truck by taking a substituted basis (the high basis of replacement truck for the low basis of relinquished truck). Thus, the exchange was invalid unless the taxpayer could show, under Code Sec. 1031(f)(2)(C), that tax avoidance was not one of the taxpayer's principal purposes for structuring the transaction as an exchange.

The taxpayer represented that it had nontax, independent business reasons for always acquiring its replacement equipment from the related-party dealer. These included the proximity of the related-party dealer's inventory to the taxpayer's business, the possibility of financing discounts for patronizing the related-party dealer and the stability of supply due to the goodwill and established business relations between the related-party dealer and the manufacturer. In addition, the manufacturer provided incentives to the related-party dealer for each unit of equipment sold by the related-party dealer. The taxpayer acknowledged that it could have obtained the replacement truck directly from the unrelated manufacturer of the replacement truck or from an unrelated dealer.

The IRS looked to the legislative history of Code Sec. 1031(f) to determine if the truck exchange fell within the non–tax-avoidance exception of Code Sec. 1031(f)(2)(C). The legislative history listed three instances in which the exception should apply: (1) an exchange of undivided interests; (2) a disposition of property in a nonrecognition transaction by one of the related parties; or (3) a non–basis-shifting transaction. The CCA stated that the taxpayer's exchange clearly resulted in basis shifting, followed by a cashing out of the high-basis property, and thus did not fit within the listed exceptions. The CCA further stated that the IRS has consistently limited Code Sec. 1031(f)(2)(C) to the situations described in the legislative history, and the IRS was not willing to expand the exception to cover the taxpayer's situation.

The CCA went on to state that while the taxpayer cited its independent business reasons as evidence that tax avoidance was not the taxpayer's *sole* objective, Code Sec. 1031(f)(2)(C) excepts transactions only if *none* of the principal purposes for the structure is tax avoidance. Thus, even though the taxpayer may have had some non–tax-avoidance reasons for structuring the exchange, immediate tax reduction was also clearly one of the taxpayer's principal objectives.

> The IRS has now issued seven private letter rulings holding that this type of related party exchange falls within the nonrecognition exception contemplated in the legislative history of Code Sec. 1031(f)(2).

In the author's opinion, the IRS has taken an overly narrow view of the non–tax-avoidance exception of Code Sec. 1031(f)(2)(C). The IRS ignored the fact that the taxpayer could have successfully deferred tax on the exchange by acquiring the replacement truck directly from the manufacturer rather than first running title through the related-party dealer. The exchange was structured with title run through the related-party dealer to obtain the nontax business advantages listed in the CCA, and not to basis shift and obtain an income tax advantage. The principal purpose of inserting the related party into the exchange was not tax avoidance.

Further, a taxpayer arguably should be able to acquire replacement property from a related-party dealer without running afoul of Code Sec. 1031(f)(4). A dealer holds property as inventory for sale to customers, and not as an investment. In both *Ocmulgee Fields, Inc.*[6] and *Teruya Brothers, Ltd.*,[7] the related parties were not dealers in real estate, but had held the replacement property in the rental business. Likewise, in Rev. Rul. 2002-83, the related party held the replacement property "for use in a trade or business or for investment." The parties in these situations, as an economic unit, sold off one business or investment property and avoided paying tax on that

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sale by reinvesting the funds in another investment property held by the same economic unit. Unlike the taxpayer in the CCA, they did not have the option of structuring the acquisition of the same replacement property from an unrelated party.

Finally, an argument can also be made that the related party's ownership of the replacement property should be ignored if the ownership is transitory and for the purpose of transferring the property to the taxpayer as replacement property in the exchange. This is supported by case law. In *Redwing Carriers, Inc.*,[8] the taxpayer, a trucking company, wanted to sell used trucks and then acquire new trucks from a manufacturer, but the taxpayer did not want to treat the transactions as an exchange under Code Sec. 1031. Therefore, the parties structured the transactions so that a truck dealer related to the taxpayer 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 dealer. Despite the fact that the related dealer, rather than the taxpayer, initially acquired the new trucks, the court found that the transactions were exchanges by the taxpayer. The court ignored the related party's transitory ownership of the replacement property as an "intracorporate fictional distinction." Applying this reasoning to the facts of the CCA, the related-party dealer's ownership could be ignored for the purposes of Code Sec. 1031(f) because the related party was a dealer acquiring property for transfer to the taxpayer. In *Redwing Carriers, Inc.*, the taxpayer inserted the related party in an attempt to break up a transaction that would otherwise have clearly been an exchange. In the CCA, on the other hand, the taxpayer inserted the related party as a business convenience and cost-saving measure, and the IRS contended that this insertion broke up the exchange. Had the taxpayer in the CCA IRS acquired the replacement equipment directly from the manufacturer, the exchange would have been valid.

Despite these arguments, the IRS has clearly indicated that it does not regard dealer transactions as an exception to the non–tax-avoidance provisions of Code Sec. 1031(f)(2)(C). This transaction would have to be disclosed on Form 8824 and an explanation attached,[9] which would seem to invite a challenge by the IRS. Therefore, these situations should be avoided until the issue is resolved by a court decision.

The IRS has set a high bar for non–tax-avoidance exceptions, other than those listed in the legislative history. Tax avoidance cannot be a principal motive and, therefore, the tax deferral in such a situation would have to be minimal, or perhaps the business reason would have to be so overriding that the tax deferral is only minor consequence of the exchange.

Application of the Nonrecognition Exception

In the second ruling, LTR 201048025,[10] the IRS approved successive exchanges by taxpayers into replacement properties owned by related parties, provided each related party would hold its replacement property for at least two years following acquisition of the property.

The taxpayer and the related party in the ruling were both REITs. In exchange #1, the taxpayer sold the relinquished property to the buyer (using a QI) and identified replacement property owned by the related party. The taxpayer would acquire all of its replacement property from the related party, and the taxpayer would hold those properties for at least two years following acquisition of the properties.

The taxpayer's replacement property in exchange #1 would then become the related party's relinquished property in exchange #2. The related party would use a QI in exchange #2, and would identify replacement properties which may include properties owned by the taxpayer or other related affiliates of the related party and the taxpayer (the "affiliates"). If the related party reinvested less than 100 percent of the value of its relinquished properties, the related party would recognize gain in the amount of the difference. The amount of the recognized gain would not exceed an unspecified percentage of the realized gain. The related party would 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 would become the respective affiliates' relinquished properties in exchange #3. An affiliate would identify and acquire replacement properties from unrelated parties. If an affiliate reinvested less than 100 percent of the value of its relinquished properties, the affiliate would recognize gain in the amount of the difference. The amount of the recognized gain would not exceed an unspecified percentage of the realized gain. The affiliate would hold its replacement properties for at least two years following the date of acquisition of the properties.

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

Each exchange had its own successive 45-day identification period and 180-day exchange period. Thus, the taxpayer effectively extended the identification period and exchange period by an additional 180 days for each successive related-party exchange, for a total maximum identification period of 405 days and a total maximum exchange period of 540 days. The IRS apparently did not regard this as an abuse under Code Sec. 1031(f), and the ruling did not address the issue of whether the structure might violate the intent of time limitations of Code Sec. 1031(a)(3).

The ruling contemplated that the related party or affiliates might receive a *de minimis* amount of taxable boot in their exchanges, and it stated that nonrecognition treatment did not apply to the extent of any such boot received. The ruling did not define what constitutes *"de minimis"* or specify the amount of the cash boot received by the related party or affiliates. It did state the boot represented only a percentage of the realized gain. Therefore, there was no basis shifting because the related party or affiliate paid tax on all the boot received.

The IRS has now issued seven private letter rulings holding that this type of related-party exchange falls within the nonrecognition exception contemplated in the legislative history of Code Sec. 1031(f)(2).[11] Thus, a taxpayer can feel confident that such an exchange would meet the non–tax-avoidance exception. However, if the taxpayer and related party want to use the nonrecognition exception, no basis shifting should occur. The related party should not receive more than a *de minimis* amount of boot, or if the boot is more than *de minimis*, it should not be in excess of the related party's realized gain. Furthermore, in light of *Teruya Brothers, Ltd.* and *Ocmulgee Fields, Inc.*, the gain recognized should be taxable at the same or a higher rate than the taxpayer's gain would have been, and the related party should pay tax on the gain and not offset it with an NOL or gain exclusion.

A taxpayer contemplating this type of related-party exchange should also bear in mind that the taxpayer is running the risk that the whole series of exchanges will be taxable if a related party does not complete its exchange (or perhaps receives more than a *de minimis* amount of boot), and the related party does not hold the replacement property for two years following the acquisition. Each exchange must be completed to meet the nonrecognition transaction exception. Thus, in LTR 201048025, if an affiliate had not completed exchange #3, then exchange #2 by the related party would also have failed; if exchange #2 failed, then exchange #1 by the taxpayer would have failed as well. As a result, the taxpayer and related parties would have incurred transaction costs and possible additional gains that could not be reversed, as well as potential ordinary income under Code Sec. 1239(b) or 707(b)(2), discussed in the earlier article.

Summary

The guidance around related-party exchanges continues to develop. The IRS has shown that it will draw a hard line in circumstances that are not specifically addressed by the legislative history. On the other hand, the IRS has been generous in allowing exceptions that do fall under the legislative history.

Endnotes

1. *Ocmulgee Fields, Inc.*, 132 TC 6, Dec. 57,777 (2009), *aff'd*, CA-11, 2010-2 USTC ¶50,565.
2. This discussion assumes that a qualified intermediary is used to facilitate the exchange; however, it also could be a three-party exchange with the taxpayer transferring the relinquished property to the unrelated buyer and acquiring the replacement property from the related seller.
3. CCA 201013038 (Apr. 22, 2010).
4. Allowed by Rev. Proc. 2003-39, 2003-1 CB 971 (May 7, 2003) for program exchanges of tangible personal property; the master exchange agreement applies to the ongoing exchanges of the taxpayer with the QI.
5. For a full discussion of these authorities, *see* Mary B. Foster, Like-Kind Exchange Corner, *Related Parties and Code Sec. 1031(f): The Do's and Don'ts*, J. PASSTHROUGH ENTITIES, July–August 2007.
6. *Supra*, note 1.
7. *Teruya Brothers, Ltd.*, 124 TC —, No. 4, Dec. 55, 924 (2005), *aff'd*, CA-9, 2009-2 USTC ¶50,624, 580 F3d 1038, *cert. denied*.
8. *Redwing Carriers, Inc.*, CA-5, 68-2 USTC ¶9540, 399 F2d 652, *aff'g* DC-FL, 67-1 USTC ¶9392.
9. *See* Line 7 and 11(c) of Form 8824 and Instructions to Form 8824.
10. LTR 201048025 (Dec. 3, 2010).
11. LTR 200440002 (Oct. 1, 2004); LTR 200616005 (Apr. 21, 2006); LTR 200820016 (Mar. 7, 2008); LTR 200810017 (Mar. 7, 2008); LTR 200820017 (May 16, 2008); LTR 200820025 (May 19, 2008); LTR 201048025 (Dec. 3, 2010).

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