Like-Kind Exchange Corner

By Mary B. Foster

The Same Taxpayer Requirement of Code Secs. 1031 and 1033: Part IV–Corporations

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Introduction

In the November–December 2009 edition, the March–April 2010 edition and the July–August 2010 edition of the Journal of Passthrough Entities, I discussed the same taxpayer requirement under Code Secs. 1031 and 1033. This requirement provides that the taxpayer who disposed of the relinquished property in an exchange under Code Sec. 1031 or the converted property in an involuntary conversion under Code Sec. 1033 (referred to as the relinquished property in this column) must acquire the new property (referred to as the replacement property in this column) to qualify for the gain deferral. If another taxpayer acquires the replacement property, the exchange or involuntary conversion will not be eligible for nonrecognition of gain treatment under these Code Secs. In the previous columns, I discussed the same taxpayer requirement for married individuals, including disregarded entities formed by the married individuals, estates and trusts, and partnerships and LLCs. In this final column on the same taxpayer requirement, I examine how it applies to corporations.

Acquisition of Replacement Property by Same Corporation

If a corporation owns the relinquished property at the time of the involuntary conversion or the exchange, the corporation, and not its shareholders, must acquire the replacement property.[1] Likewise, if the shareholder owns the relinquished property at the time of the involuntary conversion or the exchange, the corporation, as a taxpayer separate from the shareholder, cannot acquire the replacement property.[2]

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A qualified subchapter S subsidiary (QSub) is not treated as a separate corporation for tax purposes and the receipt of replacement property by the QSub should be treated as receipt by the parent S corporation for Code Sec. 1031 and 1033 purposes.[3]

While the corporation that is the taxpayer may not change during the replacement period, the ownership of the stock in the corporation may change by any percentage prior to the acquisition of the replacement property. The corporation, as separate entity from its shareholders, will remain the same taxpayer for the purpose of involuntary conversion or exchange.[4]

Consolidated Groups

Corporations that are part of a consolidated return group are still treated as separate taxpayers for the purpose of the same taxpayer requirement, and the corporation transferring the relinquished property must acquire the replacement property. Another member of the consolidated group apparently may not do so.[5]

While another member of the consolidated group may not acquire the replacement property in an exchange, the relinquished property may apparently be transferred from one member to another member of the group immediately prior to the exchange. In a recent private letter ruling, the parent of a consolidated group was allowed to acquire the relinquished property from a subsidiary corporation and then immediately transfer the relinquished property to a buyer in exchange for replacement property.[6] Code Sec. 1031 and Code Sec. 1033(g) require that the taxpayer have held the relinquished property for use in a trade or business or for investment, sometimes known as the "held-for" requirement. (The replacement property also must meet the "held-for" requirement.) It was uncertain whether the held-for requirement applied to transfers between members of a consolidated group. The IRS has taken the position in Rev. Rul. 77-337 that an individual taxpayer did not meet the held-for requirement under Code Sec. 1031 when the taxpayer received the relinquished property as a liquidating distribution from his wholly owned corporation and then immediately exchanged it for replacement property.[7] Furthermore, the IRS had issued a private letter ruling in 1984 allowing a transfer of relinquished property to a member of a consolidated group immediately prior to an exchange,[8] but the ruling was revoked ominously in 1985 with no explanation.[9]

The same corporation that disposes of the relinquished property must acquire the replacement property under Code Secs. 1031 and 1033 (and make the election to replace involuntarily converted property under Code Sec. 1033.)

The recent private letter ruling did not acknowledge any uncertainty about whether the held-for requirement applies to transfers within a consolidated group. It simply stated that the parent was considered to have held the relinquished property for productive use in its trade or business prior to the exchange. It did not provide analysis on how the IRS reached this conclusion, nor did it refer to Rev. Rul. 77-337. The IRS might have reasoned that Rev. Rul. 77-337 did not apply to transfers between members of a consolidated group because of Reg. §1.1502-13(c)(1). That regulation provides that tax attributes and holding periods are treated the same for the intercompany transactions within the consolidated group. Perhaps, the IRS was treating the held-for requirement as akin to a holding period, although the held-for requirement is not based on a specific time period. Alternatively, the IRS may have regarded the trade or business use of the relinquished property as a tax attribute.

Reorganizations During a Code Sec. 1033 Replacement Period

Code Sec. 381(c)(13) provides that the acquiring corporation in a Code Sec. 381(a) transaction "steps in the shoes" of the transferor corporation with respect to Code Sec. 1033.[10] Code Sec. 381(a) covers subsidiary liquidations under Code Sec. 332, as well as reorganizations described in Code Sec. 368(a)(1)(A) (mergers), Code Sec. 368(a)(1)(C) (stock for assets), Code Sec. 368(a)(1)(D) (divisive asset reorganizations, but only if the requirements of Code Sec. 354(b)(1)(A) and (B) are met), Code Sec. 368(a)(1)(F) (mere changes in identity, form or place of organization) and Code Sec. 368(1)(1)(G) (divisive asset transfers in bankruptcy reorganizations, but only if the requirements of Code Sec. 354(b)(1)(A) and (B) are met).

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This "step in the shoes" rule applies if any factor essential to the application of Code Sec. 1033 occurs prior to the date of the reorganization and any other factor occurs after that date. Thus, if the involuntary conversion occurs prior to the Code Sec. 381(a) transaction and the acquiring corporation receives the conversion proceeds from the transferor corporation, the acquiring corporation may make the replacement under Code Sec. 1033.[11] Likewise, if the involuntary conversion occurs prior to the date of the Code Sec. 381(a) transfer, but the conversion proceeds are not received until after that date, the acquiring corporation may acquire the replacement property.[12] Further, if the involuntary conversion occurs and the transferor corporation acquires replacement property prior to the date of the Code Sec. 381(a) transfer, the acquiring corporation may later receive the conversion proceeds and defer the gain under Code Sec. 1033.[13] This rule also applies to successive Code Sec. 381(a) acquisitions.[14] Therefore, each acquiring corporation steps into the shoes of the transferor corporation for the purposes of Code Sec. 1033.

Reorganizations During a Code Sec. 1031 Replacement Period

Unlike Code Sec. 1033, Code Sec. 381(a) does not apply to exchanges because Code Sec. 1031 is not listed in Code Sec. 381(c). However, the IRS has issued several private letter rulings holding that if the predecessor corporation transfers relinquished property in a Code Sec. 1031 exchange, the successor corporation may acquire the replacement property to complete the exchange. These private letter rulings examine the legislative history of Code Sec. 381(a) and find that: (1) Congress did not intend Code Sec. 381(c) to be the exclusive list of attributes that should be carried over after a reorganization; (2) Code Sec. 381 is not intended to affect the carryover treatment of an item or tax attribute not specified in Code Sec. 381 or the carryover treatment of items or tax attributes in corporate transactions not described in Code Sec. 381(a); and (3) no inference should be drawn from Code Sec. 381 about the utilization, under existing tax law, of any item or tax attribute by a successor or predecessor corporation.[15] Based on this legislative history, the IRS reasoned in these private letter rulings that the policy concerns that gave rise to Code Sec. 1031, *i.e.* the lack of cashing out of the investment and the administrative convenience,[16] apply equally to the nontaxable reorganizations in the rulings. Thus, the rulings hold that tax attributes carryover under Code Sec. 1031(a)(3) in the corporate reorganizations discussed in the rulings and that the successor or surviving corporation may receive like-kind property in exchange for property transferred by a predecessor corporation.

In one private letter ruling involving a Code Sec. 332 liquidation, a subsidiary corporation disposed of the relinquished property in a Code Sec. 1031 exchange. It was then liquidated into its parent. The parent also merged with another corporation in a reorganization under Code Sec. 368(a)(1). The parent was treated as the transferor of the relinquished property and therefore was allowed to acquire the replacement property during the exchange period in the exchange. [17]

In another private letter ruling, the IRS approved an exchange in which the transferor underwent a merger combined with a "spin off" during the exchange period. The taxpayer's subsidiary disposed of the relinquished property and then merged with another subsidiary under Code Sec. 368(1)(A). The stock of the successor corporation was then distributed to the shareholders of the taxpayer in a spin off in a reorganization under Code Sec. 368(a)(1)(D) that met the requirements of Code Sec. 355. The successor corporation was allowed to acquire the replacement property and was treated as the transferor in the exchange because Code Sec. 381 applied.[18]

The IRS has further ruled that two subsidiary corporations within the same controlled group may merge during the exchange period, and the surviving corporation may acquire the replacement property for the merged corporation's exchange.[19] Likewise, the IRS has ruled that a corporation may be acquired by a publicly traded REIT during the exchange period in a reorganization under Code Sec. 368(a)(1)(C), and the REIT will be treated as the transferor of the relinquished property and thus may acquire the replacement property.[20]

Conclusion

The same corporation that disposes of the relinquished property must acquire the replacement property under Code Secs. 1031 and 1033 (and make the election to replace involuntarily converted property under Code Sec. 1033.) However, shareholders may change and tax-free reorganizations may occur during the replacement period.

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ENDNOTES

[1] Rev. Rul. 73-72, 1973-1 CB 368; *W&B Liquidating Corp.*, 71 TC 493, Dec. 35,801 (1979); *Vim Sec. Corp.*, CA-2, 42-2 USTC ¶9602, 130 F2d 106; *A.K. Feinberg*, CA-8, 67-1 USTC ¶9413, 377 F2d 21.

[2] *J.C. Hill*, 66 TC 701, Dec. 33,924 (1976); however, a taxpayer may acquire replacement property under Code Sec. 1033(b)(2)(A) by acquiring control of a corporation that owns similar property.

[3] LTR 9909054 (Dec. 3, 1998).

[4] LTR 8248050 (Aug. 30, 1982).

[5] TAM 9051001 (Aug. 30, 1990).

[6] LTR 201024036 (Feb. 23, 2010).

[7] Rev. Rul. 77-337, 1977-2 CB 305.

[8] LTR 8414014 (Dec. 28, 1983).

[9] LTR 8548013 (Aug. 27, 1985).

[10] Reg. §1.381(c)(13)-1.

[11] Reg. §1.381(c)(13)-1(c)(3) Ex. 1.

[12] Reg. §1.381(c)(13)-1(c)(3) Ex. 4.

[13] Reg. §1.381(c)(13)-1(c)(3) Ex. 5.

[14] Reg. §1.381(c)(13)-1(e).

[15] H.R. REP. NO. 1337, 83rd Cong., 2d Sess. A135 (1954); Reg. §1.381(a)-1(b)(3)(i).

[16] *See, e.g., T.J. Starker*, CA-9, 79-2 USTC ¶9541, 602 F2d 1341.

[17] LTR 9751012 (Sept. 15, 1997).

[18] TAM 9252001 (Feb. 12, 1992).

[19] LTR 200151017 (Jan. 1, 2001).

[20] LTR 9152010 (Sept. 13, 1991).

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