Like-Kind Exchange Corner

By Mary B. Foster

More on Related Parties and Code Sec. 1031(f):
Tax Court Again Disallows Related Party Exchange

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.” This article provides an update to the 2007 article in light of the recent Tax Court decision in Ocmulgee Fields, Inc. In that decision, the Tax Court disallowed a like-kind exchange because it was structured to avoid the purposes of Code Sec. 1031(f) governing exchanges between related persons, and the taxpayer could not prove the transaction qualified for the non-tax avoidance exception. This article examines the taxpayer’s arguments and the inferences that can be drawn from the decision.

The Problem

A taxpayer selling relinquished property to a third party as part of a tax deferred exchange is often tempted to acquire the replacement property from a related party. Acquiring the replacement property from a related party takes the pressure off of trying to identify and acquire replacement property in the short time periods required by Code Sec. 1031. However, the acquisition of the related-party property in an exchange usually results in lower taxes overall to the taxpayer and related party than a taxable sale of the relinquished property by the taxpayer.

Taxpayers and their advisors often misunderstand the related-party rules of Code Sec. 1031(f), as the CPA apparently did in Ocmulgee Fields. The taxpayers sell their relinquished property and then acquire replacement property from a related party in an exchange, mistakenly assuming that all they need to do is hold the replacement property for two years...
following the exchange. Alternatively, they believe they can convince the IRS that the non-tax avoidance exception found in Code Sec. 1031(f)(2) should apply to the exchange. The taxpayer’s arguments in *Ocmulgee Fields* are instructive in this regard because they are similar to arguments frequently asserted by taxpayers desiring to acquire replacement property from a related party, and the opinion may convince these taxpayers to do otherwise. Further, the *Ocmulgee Fields* decision implies that penalties may be assessed hereafter in these situations, so the cost of a disallowed exchange may no longer be just the taxes plus interest.

**Facts**

The taxpayer was a subchapter C corporation controlled by George Jones and his two sons. The related party was an LLC owned by Mr. Jones and one of his sons. The taxpayer entered into an agreement to sell the relinquished property (Wesleyan Station) in July 2003. The taxpayer wanted to exchange Wesleyan Station and proceeded to search for suitable replacement property, and considered and rejected at least six possible replacement properties presented by brokers prior to the sale of Wesleyan Station. As the sale date of Wesleyan Station approached, the taxpayer considered the possibility of reacquiring a property it had sold to the related party in 1996 (the “Barnes & Noble Corner”). Five days following the disposition of Wesleyan Station, the taxpayer and the related party entered into a purchase contract, and 20 days later, the taxpayer acquired the Barnes & Noble Corner as the replacement property (using a qualified intermediary).

The taxpayer reported a deferred gain on the exchange of Wesleyan Station of $6,122,736, which would have been taxed at a corporate rate of 34 percent, thus deferring approximately $2,082,000 of taxes. The related party recognized gain on the sale of the Barnes & Noble Corner to taxpayer of $4,185,999, which was taxed at a rate of 15 percent for taxes paid of approximately $628,000. (Note the opinion does not refer to any unrecaptured depreciation at the 25-percent rate, and the related party had purchased the property in 1996, so the additional tax does not appear to have been significant.) Therefore, approximately $1.8 million of gain was deferred in the exchange, but due to the differential in tax rates, the actual tax savings were approximately $1,454,000. The taxpayer sold the Barnes & Noble Corner to the related party in 1996 on an installment basis, so the taxpayer also reported gain in the year of the exchange of $475,396 from the acceleration of gain under Code Sec. 453(e). At a 34-percent tax rate, the tax would be approximately $162,000 and would reduce the overall tax savings for the year of the exchange to approximately $1,292,000.

**Code Sec. 1031(f)(4)**

First, the Court determined whether or not Code Sec. 1031(f)(4) applied to the exchange. That subsection provides that Code Sec. 1031 shall not apply to any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of the related-party rules. To do this, the court hypothetically restructured the exchange under Code Sec. 1031(f)(1), with the taxpayer and the related party first exchanging Wesleyan Station for the Barnes & Noble Corner, and the related party then selling Wesleyan Station to a third party. In such a hypothetical exchange, the related party’s adjusted basis of $2,554,901 in the Barnes & Noble Corner would have shifted to Wesleyan Station (which, in the taxpayer’s hands, had a basis of only around $716,164). This step-up in basis resulted in the tax savings outlined above. Thus, because of this basis shifting, the exchange fell within Code Sec. 1031(f)(4) as a series of steps structured to avoid the related-party rules.

**Code Sec. 1031(f)(2)(C)**

The court then examined if the exchange fell within the non-tax avoidance exception of Code Sec. 1031(f)(2)(C), which requires that federal tax avoidance not be one of the principal purposes of the exchange. The court stated that while it is fair to infer that basis shifting transactions have federal tax avoidance as the principal purpose, there may be situations in which a taxpayer can overcome this negative inference. It then examined the three arguments put forth by the taxpayer in an attempt to show that tax avoidance was not the principal purpose: negative tax impacts, business purpose and lack of a prearranged plan.

**Negative Tax Impacts**

The taxpayer first argued that the basis shifting advantage was overridden by the following negative tax impacts:
(1) The related party was required to pay an immediate tax on its sale of the Barnes & Noble Corner. The court dismissed this argument by noting that the related party would need to pay the tax anyway if, under Code Sec. 1031(f)(1), the related party had acquired Wesleyan Station from taxpayer and then sold it to a third-party buyer. In the author's experience, taxpayers often do not understand the concept of basis shifting. They believe that if the related party is paying its tax, then the transaction should pass muster regardless of the amount of that tax. They have the further misconception that the transaction does not violate the related-party rules if the taxpayer holds the related party's property for two years following the exchange.

(2) The taxpayer's remaining gain on the installment note from the earlier sale of the Barnes & Noble Corner to the related party was accelerated. The court dismissed this factor by noting this was merely the acceleration of a deferred tax burden. Further, the taxpayer did not attempt to calculate the negative tax impact of this acceleration, most likely because the $475,396 increase in gain was obviously outweighed by the $1.8 million reduction in gain from the basis shifting and the reduction in the tax rate from 34 percent to 15 percent.

(3) The depreciation on the Barnes & Noble Corner was reduced because the taxpayer's basis was lower than the related party's basis. The court noted that the related party's adjusted basis in the Barnes & Noble Corner offset the amount it realized on the sale of that property to the taxpayer, thus producing an immediate tax benefit. Further, the proceeds of the sale, perhaps reduced by a distribution to the related party's members to pay tax, were available for reinvestment in new depreciable property.

(4) The taxpayer would pay tax at a 34-percent rate on the gain from the future sale of the Barnes & Noble Corner, rather than the 15-percent tax rate that the related party's partners would have paid had the related party retained the property. The court found this argument to be too speculative.

(5) If the related party retained ownership of the Barnes & Noble Corner, a Code Sec. 754 election could have been made on the death of Mr. Jones, eliminating 70 percent of the gain from the future sale to a third party. Again, the court responded this was also too speculative to take into account.

The court concluded that the tax savings were plain, and the taxpayer's counterfactors were "unconvincing or speculative." The court's easy dismissal of the taxpayer's negative tax impacts points out that a taxpayer cannot plan on overriding the negative inference of basis shifting with strained arguments that speculate about potential future taxes. The negative impacts should be immediately quantifiable and at least equal the benefit derived from the basis shifting.

**Business Purpose**

The taxpayer also claimed its principal purpose for acquiring the Barnes & Noble Corner from the related party was business purpose and not tax avoidance. The Barnes & Noble Corner was part of a shopping center development owned by the taxpayer, and the taxpayer wanted to reunite ownership with the rest of the development, which would yield operating efficiencies and increase the overall value of the reunited property. However, the court stated "beyond self-serving testimony, the taxpayer offered no evidence to support that claim." Importantly, the court noted that a legitimate business purpose for the exchange would not necessarily preclude a finding that the transaction had as a principal purpose the avoidance of federal income tax. Thus, following the court's reasoning, only a highly significant business purpose can save a basis-shifting transaction, such as resolving litigation between related parties. For example, if siblings inherit properties and disagree on management, they may exchange the properties to settle litigation.

**No Pre-Arranged Plan**

The taxpayer also argued that it did not structure the exchange with the intent to avoid the purposes of Code Sec. 1031(f), and there was no "prearranged plan" to acquire the Barnes & Noble Corner, unlike the taxpayer in the earlier case of Teruya Brothers, Ltd. The taxpayer stated that it had affirmatively planned all along to swap Wesleyan Station for new replacement property owned by an unrelated third party.

This lack of a prearranged plan or "last ditch" exception is the most interesting argument made by the taxpayer. The last ditch argument provides that a taxpayer may acquire replacement property from a related party in a basis-shifting transaction if
the acquisition is not prearranged at the time of the disposition of the relinquished property. The argument is derived from the following example in the legislative history of Code Sec. 1031(f) that arguably infers that a prearranged plan is required to violate Code Sec. 1031(f)(4):

[I]f a taxpayer, pursuant to a prearranged plan (emphasis added), transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031.4

The Court in Ocmulgee Fields, however, stated that a prearranged plan is not necessary to violate Code Sec. 1031(f)(4), but a prearranged plan is just one of many transactions that will fail afoul of it. Further, even if the taxpayer convinced the court that the actual exchange was not prearranged (which the taxpayer did not do), the court would still need to determine if the transaction, as hypothetically occurring under Code Sec. 1031(f)(1), fell within the non-tax-avoidance exception.

If the taxpayer in Ocmulgee Fields really wanted to rely on the last ditch argument, the taxpayer should have continued to look for replacement properties throughout the identification period and waited until almost the 45th day of the identification period before considering the Barnes & Noble Corner as replacement property. Further, the taxpayer should have identified alternatives rather than quickly entering into a purchase and sale agreement for the Barnes & Noble Corner and acquiring it by the 25th day of the exchange period. Nevertheless, even if taxpayer took these actions and the Barnes & Noble Corner were truly a last ditch alternative, the taxpayer would still be required to show that the principal purpose was not basis shifting. This might be an uphill battle given the approximately $1,292,000 in tax savings from the basis shift. Perhaps the last ditch alternative might fare better when the basis shift is minimal.

**Penalty**

The IRS wanted to apply the accuracy-related penalty of Code Sec. 6662(a). However, the Court declined to do so because Mr. Jones relied on his CPA, and the reliance was reasonable. Further, the CPA was required to interpret Code Sec. 1031(f)(4) in preparing the return, which was a difficult task due to the vague language of the statute. Teruya Bros. had not yet been decided at the time the return was filed to clarify the meaning of Code Sec. 1031(f)(4). And while Rev. Rul. 2002-83 had been issued, the court did not believe that ruling left the result free from doubt, or that the CPA had made unreasonable legal assumptions given the facts before him. The Court seemed to imply that similar transactions occurring after the issuance of the opinion in Teruya Brothers will be subject to penalties.

**Summary**

The Ocmulgee Fields decision reinforces the strict application of Code Sec. 1031(f)(4) to acquisitions from related parties when basis shifting is present. Taxpayers trying to prove a non-tax avoidance motive will face a difficult task and must have substantive and compelling countervailing factors, unlike the taxpayer in this case. The decision also throws much doubt on the “last ditch” alternative. Finally, it seems to make post-Teruya Brothers transactions subject to penalties. Note that Teruya Brothers is on appeal with the Ninth Circuit.

**ENDNOTES**

1. Mary B. Foster, Related Parties and Code Sec. 1031(f) The Do’s and Don’ts, J. PASSTHROUGH ENTITIES, July-August 2007, at 29.
5. Rev. Rul. 2002-83; IRB 2002-49, 927; 2002-2 CB 927; see article at note 1, supra, for a fuller discussion.