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Looking for Guidance —IRS Advises on "Like-Kind" Exchanges Involving Related Parties

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Under Code section 1031, a property owner who exchanges real property held for use in a business or for investment for other property "of like kind" does not recognize gain or loss, if the property received in the exchange is also to be held for use in a business or for investment and the exchange otherwise qualifies for nonrecognition treatment under section 1031. Taxpayers and their advisors have been inventive over the years in structuring transactions to maximize potential tax benefits under this nonrecognition rule.

As one example, an investor owning multiple properties through different entities, and desiring to sell one property that has appreciated without recognizing the built-in gain, might cause the entity owning that property (the "relinquished property") to exchange it for like-kind property owned by a related party with an equivalent value but a higher tax basis. Before the change in law described below, the related party could, within a few months after the exchange, sell the relinquished property for cash, and recognize a smaller gain or even a loss by reason of its higher basis.

To block such transactions and limit section 1031 to situations where the property owner and related persons do not "cash out," subsection (f) was added to section 1031 in 1989 to provide that if (i) a taxpayer exchanges property with a "related person" (as defined), (ii) the exchange would otherwise qualify for nonrecognition under section 1031, and (iii) within two years after the exchange, the related person disposes of the relinquished property or the taxpayer disposes of the property received in the exchange, then section 1031 will not apply to the exchange. Any gain or loss recognized by reason of this subsection is taken into account at the time of the disposition described in clause (iii).

Potential Abuse

Certain dispositions are excepted by paragraph (2) of subsection 1031(f) from the related party rule described above. The dispositions not taken into account for purposes of clause (iii) include: a disposition following the death of the taxpayer or the related person; a disposition by reason of certain involuntary conversions; and a disposition "with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax."

To address transactions that are potentially abusive but not squarely within the related party rule, paragraph (4) of subsection (f) then provides that section 1031 "shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection."

Apart from brief discussion in Congressional committee reports regarding the changes made to section 1031 in 1989, there is virtually no authoritative guidance regarding the scope of the anti-abuse rule of paragraph (4). The IRS has declined to give advance rulings on whether this paragraph applies to transactions involving related parties that otherwise qualify under section 1031.

A recent technical advice memorandum, however, applies section 1031(f)(4) in a manner that may well prove controversial. (A technical advice memorandum ("TAM") is issued by the National Office of the Internal Revenue Service in response to questions raised on audit of a filed return.)

TAM 9748006

The TAM describes a situation in which an individual taxpayer ("T") held a one-third interest in a parcel of unimproved land ("Property X") for investment. T's mother ("M") owned the remaining two-thirds interest in the same parcel. T and M entered into an agreement to sell their interests in Property X to an unrelated third party ("UTP").

Thereafter, M purchased another property ("Property Z") which she used as a personal residence.

T then sought to effect a like-kind exchange of his one-third interest by acquiring replacement property from another unrelated party, but was unable to complete the negotiations in time for the exchange to qualify under section 1031. When it became clear that the desired replacement property could not be acquired, T entered into an agreement to purchase Property Z from M for an amount equal to M's cost.

T, M, and UTP then engaged in an exchange transaction with a "qualified intermediary" (as defined in the applicable regulations) involving the following steps.

T assigned to the qualified intermediary ("QI") his one-third interest in Property X, his rights and obligations under the agreement relating to that property, and his rights and obligations under the agreement for the purchase of Property Z. QI then sold the one-third interest in Property X to UTP and paid the sales proceeds to M as partial payment for Property Z. T paid directly to M the balance of the purchase price for Property Z, and M transferred Property Z, via QI, to T.

Concurrently, UTP acquired M's interest in Property X for cash.

The conclusion of the TAM is that, under section 1031(f)(4), the exchange by T of his interest in Property X for Property Z did not qualify for nonrecognition treatment, because T was unable to demonstrate "that use of the qualified intermediary QI was not to avoid the purposes of the related party rules of section 1031(f)."

Space limitations do not permit the discussion here of all of the arguments made by T and of the IRS responses. The IRS analysis, however, focused principally on the circumstance that the same economic result could have been achieved more directly through an exchange between T and M of T's interest in Property X for Property Z, followed by a sale of Property X by M to UTP. Because gain would then have been recognized with respect to the exchange by reason of the related party rule of section 1031(f), T could not avoid that result "through the mere interposition of a qualified intermediary."

The analysis in the TAM that the interposition of a QI will not prevent the recognition of gain by reason of the related party rule is plausible, but it is not clear that the TAM reaches a result that furthers the purposes of section 1031(f). The consequences of the transaction arguably included a shifting of basis (from Property Z to the one-third interest in Property X) and a cashing-out by the family that is arguably inconsistent with the purposes of section 1031 and subsection (f) in particular.

Conversely, it appears that the nonrecognition treatment claimed would have been available with the same economic result if M had not purchased Property Z and T had acquired Property Z, through QI, from an unrelated party. This arguably suggests (as T in fact asserted to the IRS) that the series of transactions actually effected should not be viewed as violating the purposes of section 1031(f).

The TAM leaves open the question of whether the exceptions set forth in paragraph (2) of subsection 1031(f) to the related party rule (which exceptions permit nonrecognition of gain or loss) apply to an exchange that is not, in form, with a related party, but which is deemed under paragraph (4) to be structured to circumvent the purposes of the related party rule.

Specifically, the TAM states that "this exchange is not a related party exchange because of the use of the qualified intermediary QI," suggesting that the exceptions in paragraph (f)(2) might not be available regardless of the surrounding circumstances. It then continues, however, with the conclusion that it is not necessary to determine whether section 1031(f)(2)(C) (the no-tax-avoidance-purpose exception) applies, because T failed to establish that the exchange did not have as one of its principal purposes the avoidance of Federal income tax.

If an exchange would, if effected directly between the taxpayer and a related person, qualify under one of the paragraph (2) exceptions for nonrecognition treatment notwithstanding a subsequent disposition within two years, it would be peculiar for the IRS to contend or a court to conclude that performing the same exchange through a QI would prevent the paragraph (2) exceptions from applying and thereby cause gain or loss to be recognized by reason of the paragraph (4) anti-abuse rule.

There is some language in the TAM which could be read to suggest that the use of a QI somehow tainted the exchange by indicating a tax avoidance motive, and therefore prevented it from qualifying under section 1031.

Any implication that the use of a QI indicates an impermissible tax avoidance motive would be mistaken, however, and, according to an informal discussion with IRS attorneys dealing with Search7RH1031, no such implication was intended. The TAM does observe that the use of a QI to effect a like-kind exchange is specifically provided for in Regulation Search7RH 1.1031(k)-1.

The TAM also strongly implies that the same conclusion would have been reached if a second unrelated party had purchased Property Z from M and subsequently exchanged that property for T's interest in Property X.