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Recent Tax Court Decision Invalidates Related Party Exchange

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Can a taxpayer acquire replacement property from a related party in a Section 1031 like-kind exchange? This simple question does not lend itself to an easy answer. Authority in this area is sparse; in fact, a decision of the Tax Court last month, *Ocmulgee Fields, Inc. v. Commissioner*, 132 T.C. No 6 (March 31, 2009), is only the second case to shed light on this issue.

Under Section 1031 of the Internal Revenue Code, a taxpayer can execute a tax-free exchange of property held for productive use in a trade or business or for investment, for like-kind property held for productive use in a trade or business or for investment. As a practical matter (if the various requirements are met), a taxpayer may use a qualified intermediary (a person who is not the taxpayer, an agent of or related to the taxpayer) to facilitate a deferred exchange, an exchange in which a taxpayer can acquire like-kind property (the "replacement property") up to six months after transferring its property (the "relinquished property").

A taxpayer unable to locate suitable third-party replacement property in a timely manner may look instead to acquire property owned by a related party.

A taxpayer considering such a transaction must be aware of Section 1031(f), a provision enacted by Congress in 1989 to combat certain abuses arising from related party like-kind exchanges.

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Section 1031(f)(1) provides that if a taxpayer exchanges property with a related person in an exchange that would otherwise qualify under Section 1031, and either (A) the related person disposes of such property within two years, or (B) the taxpayer disposes of the property acquired from the related person within two years, then the taxpayer is not entitled to nonrecognition treatment under Section 1031. (The applicable definition of "related" persons includes certain familial relationships and certain thresholds of common ownership.) An important exception to this rule, found in Section 1031(f)(2)(C), disregards such disposition for purposes of Section 1031(f)(1) if it can be established that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax.

Section 1031(f)(1) on its face does not apply to a taxpayer who uses a qualified intermediary ("QI") to acquire replacement property from a related party, since a deferred exchange is treated under the regulations as a direct exchange between the taxpayer and the QI.

Section 1031(f)(4) provides that Section 1031 nonrecognition treatment will not apply to any exchange which is part of a transaction "structured to avoid the purposes of Section 1031(f)." What does this phrase mean? The legislative history of Section 1031(f) indicates that Congress enacted Section 1031(f) to combat perceived abuses resulting from "basis shifting" between related parties. Under Section 1031, a taxpayer generally takes a basis in the replacement property equal to the adjusted basis the taxpayer held in the relinquished property, thus preserving any inherent unrecognized gain. As an example: X, owner of Property 1, in which X has a low basis, engages in a like-kind exchange of Property 1 with related party Y for Property 2, in which Y has a high basis. Immediately after the exchange, X will have a low basis in Property 2, and Y will have a high basis in Property 1. If Y then sells Property 1 to a third party, Y will recognize little or no gain upon such sale, due to Y's high basis. Thus, X and Y together will have cashed out of their investment in Property 1, a property with an inherent gain, at little or no tax cost. Congress was particularly concerned with the ability of related parties to achieve this result, and enacted Section 1031(f) in part to combat this.

As discussed above, Section 1031(f)(1) combats such abuses in the case of direct exchanges between related parties. Section 1031(f)(4) was enacted by Congress as an additional precaution to prevent related persons from circumventing the purposes of Section 1031(f) by interposing an unrelated party in the exchange. The relevant 1989 House Report states as an example: "If a taxpayer, pursuant to a prearranged plan, 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, the related party will not be entitled to nonrecognition treatment under Section 1031." Since the QI is by definition an "unrelated third party," in a typical deferred exchange, has a taxpayer (who uses related party replacement property) structured the transaction using an unrelated third party (the QI) in order

to "avoid the purposes of Section 1031(f)?"

This question is at issue in *Ocmulgee Fields v. Commissioner*, a case decided by the Tax Court last month. In *Ocmulgee*, a corporation ("C") engaged in the real estate business received an unsolicited offer from a third party for the purchase of a property in which C had a low basis ("Property 1"). C decided to engage in a like-kind exchange of Property 1, and signed a contract for the sale of Property 1 which provided for a sales price of approximately $7 million, and included language indicating that C intended to execute a like kind exchange using a QI. Prior to the closing date, C consulted with its certified public accountant, real estate lawyer, and three real estate brokers as to whether there were any suitable replacement properties for sale in the area, and none were located. C decided it would acquire a property ("Property 2") from D, a limited liability company related to C, as replacement property. C already owned the remainder of the shopping mall complex in which Property 2 was located. D's basis in Property 2 was approximately $2.5 million.

The day before the closing, C entered into an agreement with a QI, and assigned its rights in the sales contract for Property 1 to the QI. On the closing date, the QI sold Property 1 to the third party buyer in exchange for the purchase price of approximately $7 million. Five days later, C entered into a purchase contract with D for the purchase of Property 2 for approximately $7 million. C assigned its interest in the purchase contract to the QI, and 20 days later, the QI transferred approximately $7 million from the sales proceeds from Property 1 to D, and Property 2 was transferred to C.

The IRS challenged C's eligibility for like-kind exchange treatment for the transactions, arguing that a QI was interposed in the transaction to avoid the purposes of Section 1031(f). The IRS argued that (1) the transactions should be viewed instead as an exchange of Property 1 and Property 2 *directly* between C and D, followed by a sale of Property 1 by D to the third party buyer for the purchase price of $7 million; (2) Section 1031(f)(1) would then apply to the recast transactions; (3) C would have failed to meet the exception in Section 1031(f)(2)(C), which required C to show that tax avoidance was not a principal purpose of the transactions; and (4) therefore, although the transaction as structured did not violate Section 1031(f)(1), C used a QI to avoid the purposes of Section 1031(f).

C argued that it qualified for like-kind exchange treatment, as follows: (1) C entered into the like-kind exchange with the intent to acquire replacement property from an unrelated person, and only when it couldn't find such replacement property did it consider acquiring Property 2 from D; (2) C had business reasons for doing so (to unite Property 2 with the rest of the shopping mall complex), and proceeded despite advice from C's accountant that this transaction would result in higher taxes; and (3) therefore, C lacked the intent to avoid the purposes of Section 1031(f).

The Tax Court agreed with the IRS. The Tax Court cited *Teruya Brothers Ltd. v. Commissioner*, 124 T.C. 45 (2005), and stated that in order to determine whether C's exchange was part of a transaction structured to avoid the purposes of Section 1031(f), it had to disregard that exchange and consider how C would have fared had it instead exchanged Property 1 with D for Property 2 and then had D sell Property 1 to a third party. The Tax Court then analyzed whether, assuming those hypothetical facts, C's exchange was subject to Section 1031(f)(1) as a direct exchange between related parties, or was excluded under Section 1031(f)(2)(C) because C could show the absence of a principal purpose of federal income tax avoidance for both its exchange of Property 1 with D, and D's deemed sale of Property 1. The Tax Court analyzed whether C had a principal purpose of tax avoidance by comparing (a) the amount of gain recognized by C in the case of C's sale of Property 1 to the unrelated third party, with (b) the amount of gain that would have been recognized by D in the case of D's deemed sale of Property 1 to the unrelated third party. Since D's basis in Property 1 was equal to D's basis in Property 2 before the exchange (and was $1.8 million higher than C's basis in Property 1), D recognized $1.8 million less gain that C would have recognized on the same sale. Thus, basis shifting had occurred in this case, which, in combination with the substitution of a 15% tax rate (applicable to income recognized by D) in place of a 34% corporate tax rate (for income recognized by C), was indicative according to the Tax Court of a principal purpose of federal income tax avoidance. The Tax Court dismissed potential offsetting factors raised by C, such as (1) certain remote unfavorable tax consequences of the transaction to C, and (2) C's business purpose for the transaction, as either unconvincing, speculative, or unverified.

On the bright side, the IRS's imposition of penalties on the grounds of negligence and substantial underpayment of income tax was reversed by the Tax Court, which determined that C, in relying on its trusted and experienced tax accountant to prepare its return, had reasonable cause for the underpayment and acted in good faith, and therefore was not liable for the penalties.

Finding replacement property is typically one of the biggest challenges facing a taxpayer who wishes to engage in a like-kind exchange. However, acquiring replacement property from a related party will not always work; a taxpayer considering such a path must be aware of the many complexities and should proceed with caution.