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Hot Like-Kind Exchange Issues

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RELATED PARTY EXCHANGES

[1] Section 1031(f): Statutory Provisions and Legislative History

[a] Statutory Provisions

Section 1031(a) of the Internal Revenue Code of 1986 (the "Code") provides, generally, that "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Code section 1031(f)(1), enacted as part of the Omnibus Budget Reconciliation Act of 1989, provides that there shall be no nonrecognition of gain or loss under section 1031 to the taxpayer with respect to an exchange if all three of the following provisions apply:

1. the taxpayer exchanges property with a related person (*i.e.*, any person bearing a relationship to the taxpayer described in Code sections 267(b) or 707(b)(1));

2. there would otherwise be nonrecognition of gain or loss under section 1031 with respect to the exchange; and

3. before the date 2 years after the last transfer which was part of the exchange either (i) the related person disposes of the relinquished property or (ii) the taxpayer disposes of the replacement property.

Any gain or loss recognized by reason of section 1031(f) is taken into account on the date of the related person's disposition of the relinquished property (or the taxpayer's disposition of the replacement property).[2] In the case of exchanges on which loss is realized, section 1031(f)(1) may cause the loss to be recognized, but other Code provisions (such as sections 267(a)(1) or section 707(b)(1)) may still prevent loss from being allowed.

Section 1031(f)(2) provides that the following dispositions do not trigger the operation of section 1031(f)(1):

1. Dispositions after the earlier of the death of the taxpayer or the death of the related person;

2. Dispositions in a compulsory or involuntary conversion (within the meaning of Code section 1033), but only if the exchange occurred before the threat or imminence of such conversion; and

3. Dispositions with respect to which it is established, to the satisfaction of the Secretary, that neither the exchange nor the disposition has as one of its principal purposes the avoidance of Federal income tax.

Code section 1031(f)(4) 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 section 1031(f).

[b] Legislative History

The legislative history of section 1031(f) states that the non-tax avoidance exception generally will apply to---

1. a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties;

2. dispositions of property in nonrecognition transactions; and

3. transactions that do not involve the shifting of basis between properties.[3]

The legislative history of section 1031(f)(4) includes the following example of a transaction structured to avoid the purposes of the related party rules:

If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two 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]

[2] Case Law Addressing Section 1031(f)

Although section 1031(f) has been part of the Code for 20 years, only in the past few years have we started seeing decisions of the courts arising under that provision. Indeed, as discussed below, an appeal from the decision of the Tax Court in its first major case under section 1031(f) was decided only in September 2009 by the Court of Appeals for the Ninth Circuit.

[a] Tax Court Decision in Teruya Brothers, Ltd.

Teruya Brothers, Ltd. v. Commissioner, 124 T.C. 45 (2005), *aff'd*, 580 F.3d 1038 (9th Cir. 2009), involving two separate exchanges, the Ocean Vista transaction and the Royal Towers transaction, was the Tax Court's first foray into the section 1031(f) arena.

[i] Ocean Vista Facts

The Ocean Vista transaction encompassed the following steps:

1. August 16, 1993: Teruya executed a letter of intent to dispose of its fee interest in the Ocean Vista Condominium complex ("OV") to the Association of Apartment Owners of Ocean Vista ("Association"), the holder of a sublease interest in the property. Association was unrelated to Teruya. By amendment to the letter of intent dated November 2, 1993, Teruya's obligation to close was made conditional on its ability to consummate a section 1031 exchange.

2. June 1994: Teruya proposed to Times Super Market, Ltd. ("Times") that Teruya acquire a replacement property ("Kupuohi II") from Times. Times was considered a "related person" to Teruya under Code section 267(b).[5] Times accepted the proposal.

3. Unstated date (apparently between June 1994 and April 1995): Times accepted Teruya's proposal.

4. April 3, 1995: Association offered to purchase Teruya's fee interest in OV. Teruya accepted Association's offer. Teruya's obligation to close was specifically conditioned on its ability to consummate a section 1031 exchange.

5. August 1995: Teruya entered into an "exchange agreement" with T.G. Exchange, Inc. ("TGE"), a "qualified intermediary" ("QI").

6. September 1, 1995: Teruya conveyed OV to TGE, TGE conveyed OV to Association, TGE received the cash proceeds of the Ocean Vista transaction (and additional cash received from Teruya) from Association and paid such cash proceeds to Times, and Times conveyed Kupuohi II to TGE.

7. Following September 11, 1995: TGE conveyed Kupuohi II to Teruya.

In sum, before the transaction, Teruya owned OV and Times owned Kupuohi II. After the exchange, Teruya owned Kupuohi II, Association owned OV, and Times had the cash proceeds from the sale of OV plus additional funds from Teruya.

Teruya realized gain of $1,345,169 from the sale of OV. On its return, Teruya, in reliance on section 1031, reported that the realized gain had not been recognized.

Times realized and recognized gain of $1,352,639 from the sale of Kupuohi II.

[ii] Royal Towers Facts

The Royal Towers transaction encompassed the following steps:

1. Before December 12, 1994: In anticipation of Teruya's sale of the Royal Towers Apartment building ("RT"), Teruya contracted to purchase two properties, "Kupuohi I" and "Kaahumanu," from Times, subject to Teruya's right to cancel the proposed purchase in the event that the sale of RT failed to proceed according to plan.

2. On or about December 12, 1994: Teruya contracted to sell RT to Savio Development Company ("Savio"), an unrelated party. Teruya's obligation to close was specifically conditioned on its ability to consummate a section 1031 exchange.

3. August 1995: Teruya entered into an "exchange agreement" with TGE.

4. August 24, 1995: Teruya conveyed RT to TGE, TGE conveyed RT to Savio, TGE received the cash proceeds of the RT transaction (and additional cash received from Teruya) from Savio and paid such cash proceeds to Times, and Times conveyed Kupuohi I and Kaahumanu to TGE.

5. Following August 24, 1995: TGE conveyed Kupuohi I and Kaahumanu to Teruya.

In sum, before the transaction Teruya owned RT and Times owned Kupuohi I and Kaahumanu. After the transaction, Teruya owned Kupuohi I and Kaahumanu, Savio owned RT, and Times held the cash proceeds from the sale of RT plus additional funds received from Teruya.

Teruya realized gain of approximately $10,700,00 from the sale of RT. On its return, Teruya, in reliance on section 1031, reported that the realized gain had not been recognized.

Times realized and recognized gain of $2,227,040 from the sale of Kaahumanu. Times realized a loss of $6,453,372 from the sale of Kupuohi I. Times's deduction for its realized loss was disallowed under section 267.

Times reported a net operating loss for its taxable year ending April 25, 1996, even taking into account the gain recognized by it from the sale of Kaahumanu in the Royal Towers transaction and Kupuohi II in the Ocean Vista transaction.

[iii] Tax Court Discussion

The Tax Court held that the transactions were structured to avoid the purposes of section 1031(f), and that, under section 1031(f)(4), Teruya was not entitled to defer the gains that it realized on the exchanges of OV and RT.

The Service did not ask the Tax Court to hold that section 1031(f)(1), which applies to *direct* exchanges between taxpayers and related parties, denied nonrecognition treatment in this case. This was consistent with the Service's apparent concession in Revenue Ruling 2002-83, 2002-2 C.B. 927, that section 1031(f)(4) governs QI exchanges and that such transactions are not governed by section 1031(f)(1) as "direct" exchanges effected through the QI as a mere agent of the taxpayer. The Tax Court observed that any attempt by the Service to treat the transactions as a direct exchange would appear to be contrary to Treasury Regulations providing that a qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a).[6] Thus, the Tax Court was left to determine only whether section 1031(f)(4) applied to the transactions as "indirect" exchanges in which the QI participated as an "unrelated party," albeit pursuant to a prearranged plan.

The Service argued, based on the example in the legislative history of section 1031(f)(4) (quoted above in Section 1.01[1][b]) that nonrecognition treatment should automatically be denied under section 1031(f)(4) if the transaction, recast as a direct exchange between the taxpayer (Teruya) and the related party (Times) and a subsequent sale by the related party, would have been described in section 1031(f)(1), without regard to the section 1031(f)(2) exceptions. The Tax Court rejected the argument, finding that further analysis was needed to determine whether the recast transaction would have been eligible for the section 1031(f)(2) exception for dispositions with respect to which it is established, to the satisfaction of the Secretary, that neither the exchange nor the disposition has as one of its principal purposes the avoidance of Federal income tax.[7] Notwithstanding the taxpayer's victory on this preliminary issue, however, the Tax Court determined that the taxpayer had failed to establish that avoidance of Federal income tax was not one of the principal purposes of the transactions, since "[t]he economic substance of the transactions remains that the investments in Ocean Vista and Royal Towers were cashed out immediately and Times, a related person, ended up with the cash proceeds," and the record disclosed no reason for Teruya's use of a QI in the transactions. The Tax Court thus inferred that the QI was interposed in an attempt to circumvent the section 1031(f)(1) limitations that would have applied to exchanges directly between related persons.

The Tax Court rejected the taxpayer's argument that its continued investment in the replacement property precluded the application of section 1031(f). The Tax Court believed that such a position would be "flatly contrary" to the words of the statute, which includes a focus on the related party's continued investment in the relinquished property as well as the taxpayer's continued investment in the replacement property. The Tax Court also rejected the taxpayer's argument that its firm intent, reflected throughout the documents, to implement only an

exchange, and not a cash sale, precluded the application of section 1031(f). The Tax Court observed that such an intent might be relevant to whether there was, on the one hand, an "exchange" or, on the other hand, a disguised sale or other transaction that did not qualify under section 1031. However, section 1031(f) presupposes that the transaction does, but for the application of section 1031(f) qualify under section 1031, and it is only otherwise qualifying transactions that are denied nonrecognition treatment.

As a final matter, the Tax Court refused to find the fact that Times recognized a greater gain on its disposition of Kupuohi II than Teruya realized on its disposition of OV meant that the OV transaction could not have had a purpose of tax avoidance. The fact that Times had available net operating losses that eliminated its actual tax liability also had to be taken into account. Thus, it was relevant to the analysis that "Times paid a much smaller tax price for that gain recognition than Teruya would have paid if it had recognized gain in a direct sale of Ocean Vista."[8]

[b] Ninth Circuit Decision in Teruya Brothers, Ltd.

In September 2009, the Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision in *Teruya*, holding that the transactions were structured to avoid the purposes of section 1031(f) and that the non-tax avoidance exception did not apply.

On appeal to the Ninth Circuit, as in the Tax Court, the Service argued that every deferred exchange between related parties involving a QI "should be recast as a direct exchange, and, if section 1031(f)(1) would preclude nonrecognition treatment for the recast transaction, then the deferred exchange should be deemed to have been structured to avoid the purposes of § 1031(f)." The Ninth Circuit rejected that argument, as had the Tax Court, "as inconsistent with the structure of the statute." According to the Ninth Circuit, a transaction will not violate section 1031(f)(4) if the taxpayer can establish to the satisfaction of the Secretary that the transaction does not have a principal purpose of tax avoidance under section 1031(f)(2). In this case, however, the Court of Appeals determined that the improper avoidance of Federal income tax was one of the principal purposes behind the exchanges. The Court of Appeals declined to address whether a reduction in the related party's loss carryovers could be a sufficient tax detriment to demonstrate lack of a tax avoidance purpose, as Teruya had not argued the point on appeal.

[c] Tax Court Decision in Ocmulgee Fields, Inc.

More recently, the Tax Court revisited section 1031(f) in *Ocmulgee Fields, Inc. v. Commissioner*, 132 T.C. No. 6 (March 31, 2009). Like *Teruya*, *Ocmulgee* involved the disposition of the taxpayer's property to a QI, the QI's sale of the taxpayer's property to an unrelated third party, the QI's acquisition of replacement property from a party related to the taxpayer, and the QI's conveyance of that replacement property to the taxpayer. Before the transaction, the taxpayer, Ocmulgee Fields, Inc. ("Ocmulgee"), owned the Wesleyan Station Shopping Center ("Wesleyan Station"), and Treaty Fields, L.L.C. ("Treaty Fields"), a partnership related to Ocmulgee for purposes of section 1031(f), owned several parcels collectively comprising "Barnes & Noble Corner." After an exchange effected through a QI,

Ocmulgee owned Barnes & Noble Corner, an unrelated purchaser owned Wesleyan Station, and Treaty Fields held the cash proceeds from the sale of Wesleyan Station.

Ocmulgee realized gain of $6,122,736 from the sale of Wesleyan Station. Ocmulgee treated the gain as not having been recognized by reason of section 1031.

Treaty Fields realized and recognized gain of $4,185,999 from the sale of Barnes & Noble Corner. Gain from the sale by Treaty Fields was taxable to its members at the 15% capital gains rate. Ocmulgee was a C corporation, so any capital gain recognized by it would have been taxed at a 34% rate.

The taxpayer in *Ocmulgee* made much of the fact that, after it had contracted to sell the relinquished property, it had made significant efforts in seeking replacement properties owned by unrelated parties, thereby negating the "prearrangement" that the taxpayer contended was what the Tax Court found troubling in *Teruya*. The Tax Court, however, rejected this attempt to distinguish *Teruya* on several grounds. First, *Teruya* did not indicate that "prearrangement" was the touchstone for determining whether or not section 1031(f)(4) would apply. The Tax Court observed that an example in the legislative history of section 1031(f) that used that term and to which the *Teruya* court referred was just that -- an example of "one of many transactions that will fall afoul of section 1031(f)(4)." Second, the Tax Court found that Ocmulgee, in fact, had a "prearranged plan" to acquire replacement property from a related party. Although the taxpayer sought replacement properties owned by unrelated parties during the period after it contracted to sell the relinquished property and before the taxpayer closed on the disposition of the relinquished property to the QI, it had become quite certain *by the time of the closing* that the only replacement property that could be found was the property owned by a related party, namely, Barnes & Noble Corner.[9]

As in *Teruya*, the taxpayer was unable to establish that neither the deemed exchange with a related party nor the deemed sale of the relinquished property thereafter had as one of its principal purposes the avoidance of Federal income tax. In the Tax Court's view, "a fair inference to be drawn from the [legislative history of section 1031(f)] is that Federal income tax avoidance generally is a principal purpose of transactions involving basis shifting," *i.e.*, where the tax basis of the replacement property, prior to the purported like-kind exchange, is higher than the tax basis of the relinquished property, the use of the replacement property's basis in computing the gain recognized on the ultimate sale of the relinquished property to a third party. In this case, if the transaction had been structured as an exchange between Ocmulgee and Treaty Fields, followed by a sale by Treaty Fields of Wesleyan Station, Treaty Fields would have recognized a gain approximately $1,800,000 less than the gain that would have been recognized by Ocmulgee if it had sold Wesleyan Station in a taxable sale, because of Treaty Fields's higher adjusted basis in Barnes & Noble Corner which would have been "shifted" to Wesleyan Station in the exchange. Moreover, the indirect exchange in this case resulted in lowering the tax rate on the recognized gain to 15%.

The taxpayer in *Ocmulgee* contended that the exchange gave rise to the imposition of a variety of income tax burdens on the taxpayer and the related party that should be viewed as overcoming the inference of a tax avoidance purpose that would otherwise arise from

the basis shifting features of the transaction. The Tax Court, although "not prepared to say that, as a matter of law, a finding of basis shifting precludes the absence of a principal purpose of tax avoidance," determined that the taxpayer was not able to overcome in this case the "negative inference" to be drawn from basis shifting and a cash out. The Tax Court found that the burdens identified by the taxpayer did not change that conclusion; some of the burdens were no worse than the results that would have followed from a fully taxable sale, others were offset by tax benefits, above and beyond the nonrecognition of gain, that the taxpayer had ignored, and a third group were "speculative."

Ocmulgee has been appealed to the Court of Appeals for the Eleventh Circuit.

[d] Burden of Proof and Penalty Issues in Teruya and Ocmulgee

In applying the section 1031(f)(2)(C) exception for "non-tax avoidance transactions," is the issue "persuading" the Tax Court or "satisfying" the Secretary? Will the courts use a high standard, such as "strong proof," in reviewing the Secretary's determination of lack of satisfaction? In both *Teruya* and *Ocmulgee*, the Tax Court ducked the issue, finding that the taxpayer did not satisfy even the ordinary standard of preponderance of the evidence.

The burden-of-proof shifting provisions of Code section 7491(a) may also be in issue in section 1031(f) cases. Because the examination in *Teruya* commenced prior to July 23, 1998, the effective date of section 7491, the provision was not implicated in that case. In *Ocmulgee*, the Tax Court found that the taxpayer had not satisfied the "credible evidence" requirement of section 7491 and, therefore, did not have to consider what impact that provision would have if its requirements were otherwise satisfied.

The Service apparently did not assert an accuracy-related penalty under Code section 6662 in *Teruya*. In *Ocmulgee*, a penalty was asserted, but the Tax Court found that the taxpayer had reasonably relied on its return preparer, and that the preparer, in turn, acting before *Teruya* had been decided (even though after issuance of Revenue Ruling 2002-83) had not made "unreasonable legal assumptions" in concluding that section 1031(f) did not apply. One would be much more nervous now about taking a position akin to that taken by the taxpayer in *Ocmulgee*. Would disclosure be sufficient to avoid a section 6662 penalty on this issue?

[3] IRS Guidance Addressing Section 1031(f)

[a] Exceptions to Section 1031(f): No Basis Shifting; Exchange of Undivided Interests

In PLR 200706001, Taxpayer owned an undivided 25% interest in Parcel #1, and Taxpayer's siblings owned the remaining 75% undivided interests in Parcel #1. A trust for the benefit of Taxpayer and her siblings owned Parcel #3. Both parcels had originally been owned by the Taxpayer's deceased father. As Taxpayer was a beneficiary of the trust, she and the trust were related persons under Code section 267(b)(6). Taxpayer transferred her 25% undivided interest in Parcel #1 to the trust in exchange for Parcel #3,[10] following which the trust and the Taxpayer's siblings sold Parcel #1.[11] Taxpayer made a representation that led the Service to

conclude that no basis shifting was occurring. The Service ruled that the trust's sale of the 25% undivided interest in Parcel #1 acquired from Taxpayer in the exchange did not cause a triggering of Taxpayer's gain on the exchange.

In reaching its holding that section 1031(f) did not apply to the subsequent disposition by Taxpayer's siblings and the trust, the Service relied on the statement in the legislative history of section 1031(f) that the "non-tax avoidance exception" will generally apply to transactions that do not involve the shifting of basis between properties. The ruling describes the taxpayer's representation as having been that "the respective per acre basis in Parcels #1 and #3 were equivalent." This representation alone seems to be an inadequate basis for concluding that there was no basis shifting, as there is no statement in the PLR regarding the number of acres in each parcel. Was the Service snookered? Or does the PLR merely not recite all the relevant facts?

In granting this ruling, was the Service also influenced by the statement in the legislative history of section 1031(f) that the non-tax avoidance exception also applied generally to exchanges of undivided interests? (Taxpayer's interest in Parcel #3 before the exchange was not a true undivided interest, but rather a beneficial interest as a beneficiary of the trust.)

In PLR 200730002, Taxpayer owned an undivided 1/3 interest, having a value of "about $2," in Greenacre and an undivided 1/3 interest, having a value of "about $1," in Blackacre, and each of Taxpayer's brother and Taxpayer's niece also owned an undivided 1/3 interest in each of Greenacre and Blackacre.[12] Taxpayer exchanged his undivided 1/3 interest in Greenacre for this brother's and niece's combined undivided 2/3 interest in Blackacre. Taxpayer's brother and niece then sold Greenacre and divided the proceeds equally. The Service ruled that Taxpayer's brother's and niece's sale of Greenacre, a 1/3 undivided interest in which had been acquired from Taxpayer in the exchange, did not cause a triggering of Taxpayer's gain on the exchange. The Service relied primarily on its understanding, based on the legislative history, that taxpayers engaging in exchanges of undivided interests among co-owners "are deemed to not have" the intent to avoid Federal income tax. The Service mentioned as a fact that Taxpayer's brother's basis was lower than Taxpayer's, so that there was, in effect, a "negative basis shift."

The Service also determined that the conclusion that Taxpayer did not have (or was "deemed not to have") an intent to avoid Federal income tax had a "natural corollary" that the transactions were not structured to avoid the purposes of section 1031(f), and that section 1031(f)(4) thus did not apply. It is interesting that the Service even considered the application of section 1031(f)(4) in the context of an apparently "direct" exchange that was not subject to section 1031(f)(1) because of a lack of tax avoidance purpose.

In this PLR, the Service also considered when "relationship" would be measured for section 1031(f) purposes. Taxpayer was the trustee of a trust of which his niece was a beneficiary. The Service stated that, if Taxpayer continued to serve as trustee of the trust, Taxpayer and his niece would be considered "related parties" for purposes of Code section 267(b)(6) (fiduciary of a trust and beneficiary of such trust).[13] The Service ruled, however, that,

if Taxpayer resigned as trustee, even if at or near the time of the exchange, the related party rules would not apply to the exchange between Taxpayer and his niece.

In PLR 200920032, Taxpayer and Taxpayer's sibling each owned a 1/3 undivided interest in Farmland through their respective grantor trusts. The remaining 1/3 undivided interest in Farmland was held in trust for the benefit of a deceased sibling's widowed spouse and children ("Trust C"). Taxpayer and Taxpayer's sibling wished to remain invested in Farmland, but Trust C wished to liquidate its interest. To facilitate each other's wishes and to increase the marketability of the interest to be sold, Taxpayer and Taxpayer's siblings, through their respective grantor Trusts, and Trust C each acquired sole ownership of a portion of Farmland in exchange for its 1/3 undivided interest in the remainder of Farmland, thereby effectively partitioning Farmland into three parcels of equal value. Trust C intended to sell its fee interest after the exchange. Trust C's basis in its undivided 1/3 interest in Farmland was higher than Taxpayer's or Taxpayer's sibling's respective bases in their undivided interests because of the "step up" in basis that occurred at the time of the death of the deceased sibling.

The Service held that (i) section 1031(f) was not applicable in the case of an exchange of interests in real property by Taxpayer with Taxpayer's sibling, because there was no second disposition of the relinquished property or the replacement property within two years of the exchange, and (ii) there was no exchange between related persons under section 1031(f) in the case of an exchange of interests in real property by Taxpayer (through its grantor trust) with a trust the trustees and beneficiaries of which were Taxpayer's sibling's widowed spouse and children, because Taxpayer and Trust C were not related within the meaning of section 1031(f)(3).

[b] Exceptions to Section 1031(f): Related Party Consummates its Own Exchange

In PLR's 200810016 and 200810017, each of Taxpayer and a related party that owned the replacement property acquired by Taxpayer completed an exchange. Taxpayer transferred its relinquished property to Taxpayer's QI, who sold Taxpayer's relinquished property to a third party buyer for cash.[14] The party related to Taxpayer transferred other property, namely, the related party's relinquished property which would become Taxpayer's replacement property, to the related party's QI.[15] The related party's QI sold the related party's relinquished property (about to become Taxpayer's replacement property) to Taxpayer's QI for cash, with Taxpayer's QI using the proceeds of the sale of Taxpayer's relinquished property. Taxpayer's QI conveyed Taxpayer's replacement property to Taxpayer to complete Taxpayer's exchange.[16] The related party's QI used a portion of the cash sales proceeds it received from the sale of the related party's relinquished property to acquire the related party's replacement property from a third party seller, which it then conveyed to the related party to complete the related party's exchange.[17] The related party's QI apparently did not use all proceeds of the sale of the related party's relinquished property to acquire the related party's replacement property, resulting in the related party's receiving some cash boot from its QI at the end of its exchange. Taxpayer represented that (i) it would hold its replacement property (the related party's relinquished property) for at least two years following the exchange, and (ii) the related party would also hold its replacement property for at least two years following the exchange.

The Service ruled that Taxpayer's exchange and the related party's exchange each qualified for nonrecognition treatment (except to the extent of the cash boot received by the related party) under section 1031. Section 1031(f)(4) did not apply, because Taxpayer had not structured the transaction using a QI to avoid the purposes of section 1031(f). There had been no "cashing out" of either party's investment in real estate. The Service concluded, based on its understanding of the legislative history of section 1031(f), that "cashing out" would be absent if:

1. upon completion of the series of transactions, both Taxpayer and the related party would own property that is of like kind to the property exchanged; and

2. neither exchangor would receive cash or other nonlike-kind property (other than some possible boot) in return for relinquished property.

These PLR's, as well as two slightly later PLR's with similar facts and conclusions (PLR's 200820017 and 200820025), are significant because the related party's receipt and retention of cash boot did not prevent either Taxpayer's exchange or the related party's exchange from qualifying under section 1031. The rulings represent an expansion of the holding of PLR 200440002, which blessed a similarly structured exchange that did not involve the retention of any cash boot, and PLR 200616005, which blessed a similar transaction in which the taxpayer but not the related party received some cash boot in the exchange.[18] The Service was presumably satisfied in the 2007 and 2008 PLR's that each of Taxpayer and the related party had sufficient continuity in its respective investment in real estate that there was no "cashing out."

The rulings, as redacted for public release, do not provide significant information regarding why the Service found the receipt of boot acceptable or the upper limit, if any, on how much boot can be received.[19] Would the Service have granted a favorable ruling if Taxpayer would have recognized a greater amount of gain than the related party on the receipt of the cash boot (for example, if the cash boot exceeded the related party's, but not Taxpayer's, gain realized)?

[c] Section 1031(f) Not Applicable After Sale of Relinquished Property to Related Party

In PLR 200709036, Taxpayer was a partnership controlled by a real estate investment trust (the "REIT"). Taxpayer transferred its relinquished property to Taxpayer's QI. Taxpayer's QI sold the relinquished property for cash to a corporation which was a "related party" to Taxpayer and a "taxable REIT subsidiary" ("TRS") of the REIT. TRS planned to sell most or all of the property it acquired from Taxpayer within two years. Taxpayer's QI used the sales proceeds to acquire Taxpayer's replacement property from an unrelated third party.

The Service held that Taxpayer's exchange was not structured to avoid the "purposes" of section 1031(f) since a direct exchange, had there been one, would have been between Taxpayer and the unrelated seller of the replacement property,[20] rather than between

Taxpayer and the TRS (the related purchaser of the relinquished property). Section 1031(f) would not have applied to that direct exchange between unrelated parties. In this case, there was no basis shifting in anticipation of the sale of the relinquished property because the related party did not own, prior to the exchange, any property that Taxpayer acquired in the exchange. TRS purchased property from Taxpayer for cash consideration at fair market value. Taxpayer did not *purchase* property from the TRS. The Service did not seem to be bothered by the fact that TRS intended to develop and to sell the property within two years.[21]

In order for a "reverse exchange" to come within the safe harbor of Revenue Procedure 2000-37, a taxpayer's replacement property can be held by an "exchange accommodation titleholder" for no more than 180 days before the taxpayer disposes of the relinquished property and takes title to the replacement property. Could the technique sanctioned by this ruling enable a taxpayer to delay the "true" disposition of the relinquished property by more than 180 days after the acquisition of the replacement property, by disposing of the relinquished property to a related party who can then resell it at leisure?

"LIKE-KIND" ISSUES

[1] Statutory Provisions and Treasury Regulations

[a] In General

Code section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind which is to held either for productive use in a trade or business or for investment.

Under section 1031(b), if a transaction otherwise qualifies as a like-kind exchange under section 1031(a), but for the fact that the property received in the exchange consists both of like-kind property and property that is not of like kind (*i.e.*, boot), then gain is generally recognized to the extent of the boot received.

Treasury Regulation section 1.1031(a)-1(b) provides:

> As used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Treasury Regulation section 1.1031(a)-1(c) includes the following examples:

> No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Treasury Regulation section 1.1031(a)-2(a) states that personal property is of like kind to other personal property if such properties are of like kind or like class. An exchange of properties of like kind may qualify under section 1031 regardless of whether the properties are also of like class. In determining whether exchanged properties are of like kind, no inference is to be drawn from the fact that the properties are not of like class.

Treasury Regulation section 1.1031(a)-2(b)(1) states that depreciable tangible personal property is of like kind to other depreciable tangible personal property if such properties are of like kind or of like class. "Like class" means either within the same General Asset Class or within the same Product Class (as defined in the regulations).

Treasury Regulation section 1.1031(a)-2(c)(1) states that an exchange of intangible personal property or nondepreciable personal property qualifies for nonrecognition of gain or loss under section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties.[22] Whether intangible personal properties are of like kind generally depends (1) on the nature or character of the rights involved (*e.g.*, a patent or a copyright) and also on (2) the nature or character of the underlying property to which the intangible personal property relates. The application of the second prong of the test is not always clear. Thus, examples in the Regulations sanction the exchange of a copyright on a novel for a copyright on a different novel, but do not sanction the exchange of a copyright on a novel for a copyright on a song.[23] May one exchange a copyright on a novel for a copyright on a nonfiction book?

The Regulations do not address whether the use that is made of intangibles is relevant in determining whether they are "of like kind." (In the case of tangible personal property subject to the "like kind or like class" rule, use is sometimes relevant (and sometimes not) under the "General Asset Classes" that can be used to make the "like class" determination; also, compare the "similar or related in service or use" applied in Code section 1033.)

[b] Goodwill

Treasury Regulation section 1.1031(a)-2(c)(2) states that the goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business. Are there some businesses that are so "nearly identical" to each other that this rule should not apply in the case of an exchange of one for the other?[24]

The scope of the denial of like-kind status to any exchanges of goodwill raises the question of whether intangible assets that are related to goodwill, such as trademarks, trade names, customer lists, or other customer-based intangibles, may be exchanged without the recognition of gain under section 1031. See discussion in Section 1.02[2][c], below, and compare Treasury Regulation section 1.338-6(b)(2)(vi) and (vii), which groups goodwill and going concern value separately from all other "section 197 intangibles," including "customer-based intangibles," franchises, trademarks, and trade names.

[2] IRS Guidance Addressing Exchanges of Intangibles

[a] Patent Cross-License Agreements

In Notice 2006-34, 2006-1 C.B. 705, the Service requested comments and information on cross-licenses, under which each of two parties that own intellectual property, typically patents, grants to the other a license with respect to specified property. The licensed rights in the respective patents are often nonexclusive and nontransferable. Thus, the cross licenses do not involve transfers of "all substantial rights" in the patents and would not ordinarily be considered dispositions thereof for income tax purposes. Nevertheless, the Service in the Notice listed treatment as an exchange, to which section 1031 might apply, as one of several possible tax treatments of cross-licenses under consideration. The Notice did not comment on the validity of any of the treatments under consideration.

Ordinarily, section 1031 can apply to a transfer only if the taxpayer has a realized gain or loss from an exchange (one particular sort of disposition) of property. Some had read the Notice to suggest that section 1031 might apply in situations where there is a cross-licensing of patent rights, even though the cross-licenses would not involve transfers of sufficient rights to support a finding that there had been a "sale or exchange" either under Code section 1235 or under general tax principles.

The Service resolved the issue in Revenue Procedure 2007-23, 2007-1 C.B. 675, at least with respect to a defined category of "qualified patent cross licensing arrangements" ("QPCLA's"), stating that the mere grant of a patent license does not result in a sale or other disposition of property within the meaning of section 1001(a), and that such grant of a patent license is therefore not eligible for nonrecognition treatment under section 1031. Similarly, the Service held, gain or loss under section 1001 does not arise in the case of mutual grants of licenses, and section 1031 has no application to a QPCLA. A QPCLA does not include an arrangement involving more than the de minimis licensing or other transfer of other intangible property including, for instance, copyrights, trademarks, and know-how.

[b] FCC Licenses of Radio and Television Stations

In the Service's Coordinated Issue Paper on like kind exchanges involving Federal Communications Commission licenses, effective May 27, 2005, the Service stated its position on several section 1031 issues arising upon the exchange of a television station for a radio station. In such an exchange, there is a transfer of the underlying tangible and intangible assets connected with each of the stations.[25] The Service concluded:

1. The exchange of an FCC license of a radio station for an FCC license of a television station is eligible for like-kind exchange treatment under section 1031;

2. A network affiliation agreement and any claimed ability to affiliate should be valued separately from the FCC license under section 1031;

3. Goodwill should be valued separately from the FCC license under section 1031; and

4. Accuracy-related penalties should be fully developed whenever a taxpayer fails to use a direct method (*i.e.*, uses the residual method) to value the FCC license.

In the Service's analysis of whether the FCC licenses were of like kind to each other, the Service looked to section 1.1031(a)-2(c)(1)'s two-prong test for intangibles (nature and character of rights granted, and nature and character of underlying property) and concluded that the differences between the FCC licenses -- differences in the assigned frequency of the electromagnetic spectrum -- were differences only in grade or quality and not differences in nature or character.

The Service stated that taxpayers need to determine the overall value of the stations being exchanged and to allocate that value among the underlying tangible and intangible assets. The underlying intangible assets may include FCC licenses, network affiliation agreements, and goodwill and going concern value, each of which needs to be valued separately. While not addressing whether a station's ability to affiliate was a separate asset apart from a network affiliation agreement, or whether the ability to affiliate exists only as part of going concern or goodwill, the Service stated that the ability to affiliate must be valued separately from the FCC license. Although the exchange of FCC licenses may be eligible for like-kind exchange treatment, an exchange of goodwill is not, and taxpayers must recognize any gain on an exchange of goodwill.

The Service stated that it was not addressing whether television network affiliation agreements and radio network affiliation agreements are of like kind to each other. The Service stated that this issue may depend on the facts and circumstances surrounding the particular agreements. (Some taxpayers attribute a negligible value, if any, to a radio network affiliation agreement, but a television network affiliation agreement may often have real value.)

In LAFA 20072101F (November 14, 2006), Taxpayer exchanged two VHF television stations and cash for a UHF television station. The stations were in different geographical markets for television stations in the United States. Each station was party to a network affiliation agreement prior to the exchange. Addressing two issues not resolved in the Coordinated Issue Paper, the Service held that the value of the exchanged television stations' ability to affiliate was part of the value of the stations' network affiliation agreements and should not be considered either a separate asset or part of the stations' goodwill and going concern

value. The Service held further that the stations' network affiliation agreements were of like kind, despite the fact that the content of the network programming was different. The Service considered, but rejected, an approach to valuing an affiliation agreement that would bifurcate the value between the value of the programs apart from the network brand and the value added by the network brand, with the latter value being inseparable from goodwill and going concern value.

[c] Patents, Trademarks, and Proprietary Information

In TAM 200602034, Taxpayer entered into four transactions in which it sold the tangible and intangible assets pertaining to two distinct businesses conducted by its subsidiaries and acquired, through its subsidiaries, the tangible and intangible assets of two new businesses. All four businesses had different SIC and NAICS codes. Taxpayer claimed like kind exchange treatment for the disposition and acquisition of the intangible assets, but did not claim like kind treatment with respect to any of the tangible assets involved in the transactions. Taxpayer claimed section 1031 applied to the exchange of five categories of intangible property: (1) patents for patents; (2) trademarks and trade names for trademarks and trade names; (3) designs and drawings for designs and drawings; (4) trade secrets and know-how for trade secrets and know-how; and (5) software for software.

The Service agreed that the first prong of the intangibles test, relating to the nature or character of the rights associated with the property, was satisfied by the taxpayer's groupings with respect to the exchanges of patents, designs and drawings, trade secrets and know-how, and software.[26]

The Service, however, found that Taxpayer had not met the second prong of the intangible test with respect to either patents or the unregistered intangibles. In the case of patents, the Service held that the second prong was not satisfied unless the underlying property to which the patents pertained were of the same General Asset Class or the same Product Class or otherwise of like kind. Taxpayer argued that patents could be grouped into four broad classes of underlying property based on United States patent law for classifying intellectual property that may be patented, specifically, (1) process, (2) machine, (3) manufacture, and (4) composition of matter, so that any machine patent would be like kind to any other machine patent. The Service found no authority, however, for Taxpayer's method of matching of patents for section 1031 purposes. The Service stated that the tax law requires the analysis of exchanges on an item-by-item basis rather than on a global basis, and that the underlying property of each patent needed to be like-kind based on its General Asset Class or Product Class or otherwise of like kind.

With regard to unregistered intellectual property, including designs and drawings, trade secrets and know-how, and software, the Service held that (a) the commonality of legal protection through trade secrets satisfied the first prong of the test (relating to the nature and character of the rights granted), and (b) the second prong can generally be satisfied only if the underlying property is in the same General Asset Class of the same Product Class (although the Service recognized this may not always be relevant). Taxpayer argued that unregistered intangibles should satisfy the second prong of the intangible like-kind property test if the exchanged properties are in the same broad categories suggested in the Uniform Trade Secrets

Act, for instance, a formula, pattern, compilation, program, device, method, technique, or process, regardless of differences in the nature or character of the property to which the intangibles related. The Service, however, noted no authority for such a broad classification, observing, that "such broad categories would permit the matching of *very* different kinds of property interests beyond the scope and intendment of § 1031."

With respect to trademarks and trade names, Taxpayer argued that all of the exchanged marks or trade names were of like kind to the extent that they fell within a corresponding category under the Lanham Act for intangible assets properly registered with the United States Trademark Office. That Act, Taxpayer noted, applies to a "word, name, symbol, or device or any combination thereof." In this case, Taxpayer argued that all of the exchanged trademarks fell within the last category, namely, a combination of words, names, symbols, or devices. The Service, however, rejected Taxpayer's argument, determining that a trademark or trade name could not be considered of like kind to another trademark or trade name, because such assets are so closely related to the goodwill of the business (which, under the Regulations, cannot be like kind to goodwill of another business). Accordingly, the exclusion for goodwill and going concern value under Treasury Regulation section 1.1031-2(c)(2) would apply to such items.

The Service held that, under section 1031(h)(2), foreign intangibles cannot be like kind to domestic intangibles.[27] Intangibles were held to be "used" for purposes of section 1031(h)(2)(A) in the location where the intangibles were enjoyed.

The Service also held that the taxpayer's "identification" of the intangible assets to be acquired as replacement property did not meet the requirements of section 1.1031(k)-1(b), in part because it was not sufficiently detailed.[28] The "identification" consisted only of (1) the name of the seller, (2) a very general description of the property (*i.e.*, "Intellectual Property, including but not limited to patents, trademarks, copyrights, software, know how, designs and other intellectual property assets as may be owned, licensed by or leased by the seller"), and (3) estimated value. There were no descriptions of the underlying property pertaining to any of the intangible assets.

[d] Mastheads and Newspaper Advertising and Subscriber Accounts

In LAFA 20074401F (September 25, 2007), Taxpayer exchanged a newspaper business for another newspaper business. The Service held that the exchanged newspapers' (1) mastheads were not of like kind, (2) advertising accounts were not of like kind, and (3) subscriber accounts were not of like kind. The Service concluded that the mastheads, advertising accounts, and subscriber accounts were so closely related to (if not a part of) the goodwill and going concern value of a business that they could not be exchanged as like-kind property under the *per se* rule in the Regulations regarding goodwill. See Treas. Reg. § 1.1031(a)-2(c)(2). Taxpayer argued that the Service's position was not consistent with *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993), in which the Supreme Court held that a newspaper's subscriber lists could be separable from the newspaper's goodwill and thus depreciable under Code section 167.[29] The Service rejected Taxpayer's argument, stating that the relevant question was not whether intangibles are depreciable because they have a limited useful life, the duration

of which can be ascertained with reasonable accuracy -- which had been the issue in *Newark Morning Ledger* -- but whether an intangible that is closely related to, if not a part of, goodwill and going concern value is of like kind to another intangible that is closely related to, if not a part of, goodwill and going concern value. The Service acknowledged that Code section 197 recognizes trademarks and trade names as assets separate from goodwill, but considered that fact irrelevant.

In CCA 200911006, the Service reversed its prior position and held that intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill can qualify as like-kind property under section 1031. The Service stated that, except in rare and unusual circumstances, such intangibles can be separately described and valued apart from goodwill. The Service concluded that the analysis of *Newark Morning Ledger* does apply in determining whether intangibles constitute goodwill or going concern value for section 1031 purposes.

The Service will no longer follow the rationale of TAM 200602034 and LAFA 20074401F on this issue.

[3] IRS Guidance Addressing Depreciable Personal Property

In PLR 200912004, Taxpayer operated a vehicle leasing business. Taxpayer exchanged a number of its cars, light general purpose trucks (having unloaded weight of less than 13,000 pounds), and vehicles that share characteristics of both cars and light purpose trucks for another group of vehicles. Taxpayer combined all the vehicles into a single exchange group, taking the position that they were all of like kind, even if not of like class. The Service agreed, holding that the vehicles differed only in grade or quality and were of the same nature and character and were, therefore, of like kind. In its analysis, the Service discussed changed circumstances arising from the evolution of motor vehicles over the past few decades, which has blurred some of the distinctions between cars and light-duty trucks. The Service made no negative inference from the fact that the cars and light trucks were listed in separate General Asset Classes.

[4] Is It "Real Property"? Impact of State Law Labels

The Treasury Regulations under section 1031 contain several provisions that have led to the broad generalization that "all real property is of like kind to all other real property."[30] Treasury Regulation Section 1.1031(a)-1(b) provides, "The fact that any real estate involved [in an exchange] is improved or unimproved is not material [to the determination of whether the exchanged properties are of like kind]." Treasury Regulation Section 1.1031(a)-1(c)(2) provides, "No gain or loss is recognized if ... a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate."

The Regulations do not state what impact state law definitions of "real property" may have on the determination of whether an interest in property constitutes real property that may be exchanged for any other sort of real property under section 1031. Compare Treasury

Regulation sections 1.48-1(c) (local law not controlling for purposes of determining whether property is personal), incorporated by reference in Treasury Regulation section 1.1245-3(b)(1) definition of "personal property," which is in turn incorporated by reference in section 1.1250-1(e)(3)(1) definition of "real property," and 1.856-3(d) (local law definitions not controlling for purposes of determining meaning of term "real property" as used in Code section 856, relating to real estate investment trusts).

[a] IRS Guidance Addressing Impact of State Law

[i] State Law Treated as Dispositive in Like Kind Analysis

In some situations, the fact that an interest in property is denominated "real property" for state law purposes has apparently been dispositive, in and of itself, for section 1031 purposes.

In PLR 200631012, a partnership exchanged shares of stock in several New York cooperative housing corporations for improved and unimproved real property. The partnership had been holding the apartments leased under the proprietary leases associated with the shares for rental purposes. The Service held that the shares were of like kind to the replacement properties. The Service seemed to rely only on the fact that some New York statutes treated an interest in a cooperative apartment as "equivalent to an interest in real property."[31] The Service stated, "whether stock in a cooperative apartment located in New York State constitutes real or personal property under section 1031 is determined under New York law." The Service did not require that New York State law be uniform in its treatment of the stock, noting that some New York cases might suggest there are conflicts whether an interest in a cooperative is real property.

[ii] State Law Ignored in Like Kind Analysis

Some rulings have stated explicitly that state law is not relevant and that whether properties are like kind for purposes of section 1031 is a matter of Federal law.

In Revenue Ruling 2004-86, 2004-2 C.B.191, the Service held that the exchange of an interest in real property for all of the beneficial interests in a Delaware statutory trust owning real property qualified under section 1031 as a tax free exchange. Under Delaware law the trust was an entity recognized as separate from its owners, and a beneficial interest in the trust was personal property. Nevertheless, for Federal income tax purposes the owners of a beneficial interest in the trust were considered to own the trust assets attributable to that interest. Thus, the Service held that the exchange of an interest in real property for an interest in the trust would be treated as an exchange of real property for an interest in real property for purposes of section 1031. See also PLR 200709036, described in Section 1.01[3][c], above, where Taxpayer relinquished 100% of the limited liability company interests in its wholly owned limited liability company that owned real property. In determining whether section 1031 applied, the Service ignored the state law characterization of the transferred interests as entity interests, and looked only to the Federal income tax characterization of the interests as interests in real property.

[iii] State law Relevant, but Not Determinative, in Like Kind Analysis

In some recent PLR's, the Service has discussed both state law labels and other factors in making the determination of whether or not properties are of like kind, in effect, using the state law characterization as a necessary, but not sufficient, condition for determining whether the exchanged properties could potentially be like kind.

In PLR 200805012, Taxpayer intended to exchange real property owned in fee for transferable development rights which Taxpayer would then record with respect to a second real property it owned in the same city as the relinquished property. The development rights, as applied to Taxpayer's property, permitted Taxpayer (or its lessee) to develop that property with greater floor space than would otherwise have been allowed without the development rights. The Service held that the development rights were of like kind to the relinquished fee interest in real property. In reaching its holding, the Service first looked to the characterization of the development rights under state and local law. While noting that it was unclear whether development rights were treated as interests in real property for *all* purposes of State law, the Service stated that it was sufficient that some portions of the State tax statutes treated the rights as an interest in real property. As a second step in its analysis whether the development rights were like kind to the relinquished fee interest, the Service determined that the development rights were "analogous to perpetual rights," noting that development rights did not exist at the discretion of a city agency or other decision-making authority and had no expiration date.

In PLR 200901020, Taxpayer intended to exchange residential development rights with respect to certain parcels of real property for hotel development rights, a fee interest in land, and a leasehold interest in real estate of 30 years or more remaining. The Service held that the relinquished development rights were of like kind to the development rights pertaining to hotel development, the fee interest in real property, and the long-term lease. The Service looked to both the characterization of the development rights under State law and to whether the development rights were effectively of perpetual duration. Since the rights were in perpetuity and were directly related to taxpayer's interest, use, and enjoyment of the underlying land, the Service concluded that the development rights were of like-kind to the fee interests in property.[32] It is interesting that, in reaching its holding, the Service used the example in the Regulations of an exchange of a fee interest in real estate with a lease as support for its position that State law characterization of a property right as an interest in real property is not sufficient for an exchange to qualify under section 1031:

> Not all interests defined as real property interests for state law purposes, are of like-kind for purposes of Section 1031. Although the Service generally looks to state law in determining what property rights constitute real property interests, such classifications are not necessarily determinative of what real property interests are of like-kind to other real property interests under federal income tax law. That determination is a matter of federal, not state, law. For example, even if a short-term lease (any lease having a term of less than 30 years with extensions) is an interest in real property under state law, it is not of like kind to a fee interest in real estate. However, as noted above in § 1.1031(a)-1(c)(2), long-

term leasehold interests in real estate with 30 or more years to run are of like kind to other real estate.

[iv] Significance of Differences in State Law Characterization

If State law characterization is a necessary, even if not sufficient, condition for determining whether an exchange qualifies for nonrecognition under section 1031, differences in State law can take on large significance under the view that an exchange of real property for personal property does not qualify *per se* for section 1031 treatment.

In TAM 200424001, Taxpayer and its subsidiaries operated Class I railroads throughout the United States and built and maintained track on its own rights of way. Taxpayer exchanged both intact rail line segments and rail and ties that had been removed from a line segment for new component materials with which to manufacture replacements for its track system. The Service held that relinquished property consisting of components of railroad track that are assembled and attached to the land and considered real property for State law purposes are not like kind under section 1031 to unattached components, which are personal property under applicable State law. The Service assumed for purposes of the TAM that the intact line segments exchanged by Taxpayer were real property under applicable State law. In reaching its holding, the Service noted that it was "well-established in case law that real property is not of the same nature or character as personal property" and therefore "are not like kind under § 1031(a)."[33]

If differences in state law labels, standing alone, can be sufficient to prevent an exchange from qualifying under section 1031, one could reach the odd conclusion that an exchange of tangible business property located in one state for physically identical property, used in the same business and in the same manner in another state, was fully taxable. This argument was made by Taxpayer in TAM 200424001. The Service acknowledged this possible result, but was not bothered by it, stating, "It is well-established that '[i]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayers had in the property or income sought to be reached by the statute.' *Morgan v. Commissioner*, 309 U.S. 78, 82 (1940). Thus, since state law controls whether property is realty or personalty for federal income tax purposes, it is not uncommon for the federal income tax treatment of such property to vary depending on the controlling state law (e.g., the rules relating to depreciation)." The Service's reliance on *Morgan* for this argument has been harshly criticized.[34]

[b] Tax Court Decision in Peabody Natural Resources Co.

In *Peabody Natural Resources Co. v. Commissioner*, 126 T.C. 261 (2006), Taxpayer exchanged the assets of a gold mining business for the assets of a coal mining business. In the exchange, the taxpayer assumed all obligations of the seller under two long-term coal supply contracts entered into with power companies. Taxpayer treated the gold mines, coal mine reserves, and appurtenant supply contracts as part of the same exchange group comprising real property. The first supply contract made the taxpayer the exclusive supplier of coal to the power company as required by the power company for operation of its power plant. The contract required the power company to purchase a specified annual minimum amount of coal and

prohibited the taxpayer from selling coal to others if such sales would impair its ability to supply coal to the power company. The second contract also made the taxpayer the exclusive supplier of coal to a power company for use in its power plant, included a minimum quantity of coal to be supplied under the contract, and required the taxpayer to maintain coal reserves adequate to supply the quantity of coal called for under the contract. The per-ton price of coal under both contracts was a based price adjusted for the taxpayer's costs incurred by the taxpayer in supplying coal under the contract.

The Tax Court held that the coal mine subject to the supply contracts was of like kind to the relinquished gold mining property and that the coal supply contracts were not taxable boot. Although the taxpayer was obligated to mine and supply coal to meet the operating needs of power stations and prohibited from impairing the contracted-for supply by selling coal to other buyers, the Tax Court noted, "In our view those contract obligations and restrictions constitute a distinction in the grade or quality of the old and new mining properties rather than a difference in their kind or class." Both Taxpayer and the Service appear to have agreed that State law was relevant in determining whether this was a "like-kind" exchange, and, in reaching its holding, the Tax Court looked to whether the coal supply contracts constituted an interest in real property under State law. The Tax Court held that the coal supply contracts created servitudes under State law and that those servitudes were real property interests under State law. The fact that the contracts were also contracts for the sale of goods under a different portion of State law did not preclude a holding that the contracts were interests in real property.

[5] Exchanges of Leasehold Interests

The Tax Court in *Peabody* referred to cases where the courts have held that a short-term leasehold of real property is not equivalent to a fee interest for purposes of section 1031. The Tax Court explained, "this characterization of short-term leasehold interests derives not from any particular State law characterization but from negative implication of long-standing regulations which provide that an exchange of a 30-year lease for a fee interest qualifies as a like-kind exchange under sec. 1031."[35] Under these Regulations, an existing leasehold with 30 or more years to run can be acquired as replacement property for a relinquished fee (or 30+-year leasehold) interest. Can a leasehold with 31 years to run be acquired as replacement property for a relinquished leasehold with 29 years to run? Can any leasehold with less than 30 years to run be acquired as replacement property for a relinquished leasehold with less than 30 years to run? Is a one-year leasehold of like kind to a 29-year leasehold?

HAS THERE BEEN AN "EXCHANGE"?

The statutory requirement that there be an "exchange" -- that is, a "reciprocal transfer of property"[36] -- has generated some controversy. The taxpayer must "transfer" or "dispose of" property; it is well established that no "exchange" exists when the taxpayer has merely leased its own property to another person.[37]

[1] Improvement Exchanges

When the replacement property consists of (or includes) improvements to land in which the taxpayer holds (or has held) an interest, questions have arisen with respect to whether the consideration received by the taxpayer has consisted of the "transfer" of property to the taxpayer. It is clear that the cost of constructing a building on land already owned by the taxpayer cannot be treated as an investment in replacement property. *See Bloomington Coca Cola Bottling Co. v. Commissioner*, ¶ 50,190 P-H T.C. Memo. (1950), *aff'd*, 189 F.2d 14 (7th Cir. 1951), where Taxpayer: (i) engaged a contractor to build a new plant for Taxpayer on Taxpayer's property, (ii) transferred cash and Taxpayer's old plant and land thereunder to the contractor, and (iii) reported the transaction as a like-kind exchange. The Court of Appeals affirmed the Tax Court's holding that there was no exchange and that there was a sale by Taxpayer of its old plant which resulted in a recognized loss.[38]

Even if the land is "parked" with a third party while the building is being constructed, but beneficial ownership remains with the taxpayer throughout the construction period, neither the land (since it is treated as owned by the taxpayer for Federal tax purposes) nor the improvements constructed thereon will be considered replacement property, and there will be no like-kind exchange. *See DeCleene v. Commissioner*, 115 T.C. 457 (2000). However, a building constructed on land acquired from a third party by an exchange accommodation titleholder ("EAT") may constitute replacement property when the property is ultimately conveyed from the EAT to the taxpayer. *See* section 4.03(5) of Revenue Procedure 2000-37.

The taxpayer may acquire an outstanding leasehold interest having 30 years or more to run in property owned by the taxpayer, thereby reacquiring the right to possession. Revenue Ruling 68-394, 1968-2 C.B. 338.[39] The Service has also ruled favorably in cases in which development rights were acquired as replacement property and used to implement the further development of property already owned by the taxpayer. *See* discussion of PLR's 200805012 and 200901020 in Section 1.02[4][a][iii], above.[40]

The Service has made the blanket statement, "[I]mprovements that are conveyed without land are not of like kind to land."[41] This seems clearly incorrect in many situations. Take, for example, a taxpayer who relinquished a fee interest in land and/or building. The taxpayer should be able to acquire as replacement property a leasehold interest in land which has 30 years or more to run on which the lessee had theretofore erected a building of which the lessee was considered the owner for Federal income tax purposes.[42] However, the Service's statement may make sense in the case of a taxpayer acquiring improvements on its own property.

Can the payment of advance rent as consideration for the granting of a leasehold interest to the taxpayer constitute an acquisition of replacement property?[43] Does it matter whether or not the rent is recharacterized as a loan from the taxpayer to the lessor under Code section 467? Can the taxpayer treat as replacement property a leasehold interest purchased from a lessee who has made such a prepayment?

[2] Exchanges After a Partnership Division

In PLR 200921009, property of a partnership was involuntarily converted. The partners of the partnership disagreed on whether to replace the converted property with similar use property or to diversify its investments by acquiring non-similar use property. Before the partnership acquired replacement property, it was divided into three separate partnerships, each of which was considered a "continuation" of the original partnership under Treasury Regulation section 1.708-1(d)(1). The Service ruled that replacement property acquired by each continuing partnership would be taken into account in computing the amount of gain recognized by the divided partnership under Code section 1033.

Could similar pr1inciples be applied in the case of a partnership that had disposed of relinquished property in a section 1031 exchange but had not yet acquired replacement property? Does this technique hold promise for dealing with the perennial problem of some partners' wanting to receive cash when other partners prefer full nonrecognition treatment?

QUALIFIED INTERMEDIARIES

[1] Bankruptcy and Defalcation

[a] Background

In 1991, Treasury Regulation section 1.1031(k)-1 was promulgated, pursuant to which a "qualified intermediary" ("QI") may be used to facilitate multi-party, deferred like-kind exchanges. Under the Regulations, a QI is a person who enters into a written agreement with the taxpayer (the "exchange agreement"), and, as required thereby, acquires the relinquished property from the taxpayer, transfers the relinquished property to the buyer, acquires the replacement property from the seller, and transfers the replacement property to the taxpayer.[44] Because the Regulations permit the use of "directed deeds," it is fairly uncommon for QI's actually to take title to the relinquished or replacement properties.[45] However, the QI will typically hold the cash proceeds of the sale of the relinquished property until the taxpayer is ready to acquire the replacement property. Under Code section 1031(c)(3)(B), the taxpayer's acquisition of the replacement property must be completed within 180 days after the taxpayer's transfer of the relinquished property.

In order for the QI's receipt and holding of cash proceeds not to be considered the receipt of taxable cash boot by the taxpayer under the doctrines of agency and "constructive receipt," the exchange agreement must contain express limits on the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or other property held by the QI until the end of the 180-day exchange period. In order to protect the taxpayer against loss of the proceeds of the disposition of the relinquished property while those proceeds are being held by the QI, the Regulations permit the use of certain security or guarantee arrangements, qualified escrow accounts, and qualified trusts. Some taxpayers' lawyers have long been insistent that such security devices be used whenever funds are held by a QI, but that has not been the universal practice.[46] The detailed requirements for a qualified escrow account or qualified trust are set out in section 1.1031(k)-1(g)(3). One crucial requirement is that, like an exchange

agreement with a QI, a qualified escrow agreement or qualified trust agreement must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or other property held in the escrow account or trust until the end of the exchange period.

In most jurisdictions, QI's have not been subject to specific regulation. On August, 18, 2008, the Federal Trade Commission denied a petition filed by the Federation of Exchange Accommodators requesting the regulation of QI's in order to prevent unfair or deceptive acts or practices. The FTC stated that, after evaluating the likely prevention of future harm from such regulation, the substantial cost to the industry, and the overall incidence of malfeasance, it determined that the rulemaking requested was not appropriate, but that it would continue to monitor consumer complaints and to make appropriate referrals to criminal authorities.

[b] Recent Developments Regarding Failed QI's[47]

Within the past several years, several QI's have had significant financial problems leading to insolvency or bankruptcy. For example, in November, 2008, LandAmerica 1031 Exchange Services, Inc. and its parent corporation, LandAmerica Financial Group, Inc., that had guaranteed its obligations, filed for bankruptcy protection. In some cases, there has been theft or misappropriation of taxpayer funds. Some QI's have improperly applied customer assets for the QI's personal use or to make risky business or personal investments. These circumstances create both economic and tax problems for taxpayers.

The taxpayer suffers an economic loss to the extent that it is unable to recover the funds that are held by the QI. Even if most or all of those funds are ultimately paid to (or for the account of) the taxpayer, the bankruptcy process can be slow, painful, and expensive. Meanwhile, the taxpayer may find itself in default under its contract to acquire the replacement property, if the taxpayer cannot find other funds to effect that acquisition.

The results of a QI failure may also have harsh tax results. As noted above, section 1031(a)(3)(B) requires that the taxpayer acquire the replacement property within 180 days after the transfer of the relinquished property. If the QI's default, insolvency, or bankruptcy prevents the taxpayer from acquiring the replacement property on a timely basis, the taxpayer's entire realized gain on disposition of the relinquished property will be recognized. While the loss of the proceeds that were being held by the QI may reduce the amount of the taxpayer's gain, the taxpayer would at the least be required to recognize any "phantom" gain attributable to an excess of liabilities over basis with respect to the relinquished property. If, as, and when funds are ultimately recovered from the QI (or its principals or bankruptcy estate), the taxpayer will recognize gain that cannot be deferred under section 1031.[48]

The Service took the position in a June 6, 2008, letter to Representative William Delahunt (INFO 2008-0021) that, if a QI fails, as a result of its bankruptcy, to acquire the replacement property and to transfer it to the taxpayer within the 180-day exchange period, the taxpayer's entire gain realized will be recognized. The letter does not specify how the gain realized is computed, when the gain is recognized, and whether the gain can be reported on the installment basis. (*But see* Code section 453A, imposing an "interest charge" on gain deferred

under the installment method.) The letter acknowledges that, in some circumstances, the taxpayer may, in fact, be allowed a loss under Code section 165.

However, there are indications that the Service is now exploring whether it can relieve some of these difficulties.

1. The Treasury Inspector General for Tax Administration's Report on the use of QI's, dated August 27, 2008 (Reference Number 2008-30-154), encourages taxpayers to consider using the other safe harbors rather than the QI safe harbor and recommends that a specific caution about the potential risks involved with using a QI be included in the Service's publication Sales and Other Dispositions of Assets (Publication 544).

2. There is an item on the IRS/Office of Tax Policy 2009-10 Priority Guidance Plan titled, "Guidance under § 1031 regarding exchange fund accounts held by a qualified intermediary." Such guidance, when issued, may render the other authorities cited in this section obsolete.

3. In a letter dated February 4, 2009, from Michael Montemurro (branch chief, Office of Associate Chief Counsel) to Representative Jerry Costello (INFO 2009-0017), the Service denied a request from a taxpayer requesting immediate emergency relief from the Service in connection with the taxpayer's inability to complete its section 1031 exchange in a timely manner. The letter states that the statutory replacement period under section 1031 can be extended only when authorized by statute, and that the only such statutory authority is Code section 7508A, authorizing extension of the replacement period for taxpayers affected by a federally declared disaster or a terroristic or military action. The letter stated that the "bankruptcy of a QI and its significant adverse consequences do not qualify under section 7508A.

4. In subsequent letters to the same effect, however, the Service indicated that it was "considering some type of relief for taxpayers in this situation," that it understood that "a bill pending in the House of Representatives (H.R. 1301) would suspend the 180-day period in the case of bankrupt QI's,"[49] and that it was "independently coordinating with the Office of Tax Policy at the Treasury Department to determine whether it could provide relief through published guidance or other administrative means." See letters dated March 26, 2009, from Michael Montemurro to Senator Christopher Dodd (INFO 2009-0063) and dated May 14, 2009, from George J. Blaine (Associate Chief Counsel) to Representative Earl Blumenauer (INFO 2009-0106).

5. In a letter dated June 12, 2009 to Senator Christopher Dodd, David P. Vandivier, Acting Assistant Secretary (Legislative Affairs), Department of the Treasury, stated that "we are considering the tax policy implications of

current law and evaluating the scope of our authority in this area to issue administrative guidance."

Taxpayers and their counsel should conduct thorough due diligence on any potential QI and should carefully review the QI's documentation and structure. Taxpayers also should consider requiring the QI to use a qualified trust for greater security.

Several states (including California, Nevada, Idaho, and Colorado) have enacted or are considering regulation of QI's and/or requiring that separate accounts be maintained in escrow or through a trust.

[2] Taxation of Income Earned on Funds Held by QI

Many exchange agreements state that the taxpayer will receive all income earned by the QI on investment of the proceeds of disposition of the relinquished property. On July 9, 2008, Treasury Regulation sections 1.468B-6, 1.7872-5, and 1.7872-16 were promulgated, applicable to transfers made on or after October 8, 2008. Under those provisions, if an exchange agreement does not entitle the taxpayer to all of the income earned on investment of the proceeds of disposition of the relinquished property, those proceeds are treated as having been loaned by the taxpayer to the QI, generally at an interest rate equal to the interest rate on a thirteen-week Treasury bill, and the QI takes into account all items of income and deduction attributable to the exchange funds.[50] There is an exemption from this rule, and no interest will be imputed to the taxpayer, for exchange funds of $2 million or less.[51] If the exchange agreement does entitle the taxpayer to all of the income earned on investment of the proceeds of disposition of the relinquished property, the proceeds will not be treated as a loan and all of the interest income will be taxed to the taxpayer.[52] In either case, interest is to be reported by the taxpayer in the year earned (not in the year actually received). See section 1.468B-6(e), Example 1.

The QI may be required to issue a Form 1099 to the taxpayer.

[3] Other Significant Developments Involving QI's

[a] Definition of "Disqualified Person"

In PLR's 200803003 and 200803014, an entity and its subsidiaries were engaged in providing financial services to clients, including investment advisory, brokerage, and financial planning services, insurance sales and advising, retail banking services, and an "array of trust and estate services traditionally associated with trustees." The entity wanted to expand the business of one of its banking subsidiaries to include the provision of QI services to clients of the other financial service businesses.

Treasury Regulation section 1.1031(k)-1(g)(4) provides that a "qualified intermediary" is a person who is not the taxpayer or a "disqualified person" as defined in section 1.1031(k)-1(k). Section 1.1031(k)-1(k)(2) states that an "agent of the taxpayer at the time of the transaction" is a "disqualified person." Under this section, a person is treated as an agent of the taxpayer at the time of the transaction if the person has "acted as the taxpayer's employee,

attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties." Certain services are not taken into account for purposes of determining whether a person is treated as an agent under this section, including "services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031" and "routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company."

Persons who are "related" to a person who is (or is treated as) an "agent of the taxpayer at the time of the transaction" are also "disqualified persons."[53] "Relationship" is generally determined under Code sections 267(b) and 707(b), but using a 10%, rather than a 50%, ownership test. A "bank" (or "bank affiliate," as defined in section 1.1031(k)-1(k)(4)(ii)) will not be a "disqualified person" solely by reason of certain relationships with persons who have provided investment banking or brokerage services to the taxpayer.

In the rulings, the Service concluded that the activities of the insurance sales and advisory affiliate of the proposed QI did not cause that affiliate to be the "agent" of its customers under the Supreme Court's "nominee" cases (*National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949), and *Bollinger v. Commissioner*, 488 U.S. 340 (1988)). The Service also concluded that the services rendered to customers by the proposed QI's retail banking and trust affiliates and by the proposed QI itself did not establish an agency relationship of the kind described in *National Carbide* or *Bollinger*. Moreover, the Service concluded that these services, including principal and income accounting, fiduciary income tax services, distribution and valuation services, charitable trust services, bill payment, probate related services, discretionary investment and asset management services, consumer and small business lending, home financing, margin lending and other extensions of credit, retirement services and custodial services, check writing, direct deposit, online bill payment, and fee-refunded ATM transactions, constituted "routine financial or trust services" rendered by financial institutions within the exception under Treasury Regulation section 1.1031(k)-1(k)(2)(ii) and, therefore, were not taken into account in determining whether the proposed QI was a disqualified person. The activities of the investment banker or broker affiliate would also not be taken into account, because the QI was a bank and the exception under Treasury Regulation section 1.1031(k)-1(k)(4)(ii) applied. Accordingly, the Service held that the proposed QI would not be a "disqualified person" with respect to clients of its affiliated entities' financial businesses.

[b] Midstream Change in Tax Classification of QI

In PLR 200908005, each of three QI's had been classified as a qualified subchapter S subsidiary disregarded, for Federal tax purposes, as an entity separate from the S corporation that owned 100% of its stock. All of the stock of each QI was transferred by the S corporation to a limited liability company wholly owned by a C corporation. The transfer caused the QI's to be classified as separate C corporations for Federal tax purposes. This change in classification occurred after the QI's had acquired relinquished properties from several taxpayers, but had not yet conveyed replacement properties to them.

Under section 1.1031(k)-1(g)(4)(iii)(B), a QI is a person who, *inter alia*, "acquires the relinquished property from the taxpayer, transfer the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." If the person who acquires the relinquished property from the taxpayer is considered, for Federal tax purposes, to be a different person from the person who transfers the replacement property to the taxpayer, one might worry that no QI at all was present -- since no one person would take the four actions required by the Regulation quoted above -- and that the taxpayer was therefore considered to be in constructive receipt of the funds held by the putative QI.[54]

In the ruling, the Service held that the change in the QI's tax classification and identify did not invalidate the exchanges because the legal identity of each QI did not change and, for state law purposes, the entity providing the services before the transfer was no different from the entity that provided the services after the transfer.[55] The Service also took into account the Taxpayer's representation that, following the change of ownership of the QI's, it did not intend to change the manner in which the QI's conducted business or their forms of legal organization.

One might have thought that the fact that the entity before and after the transfer is the same for local law purposes is meaningless under the Internal Revenue Code, since the C corporation is considered a new entity for tax purposes. Yet the Service did not find this problematic.

This ruling provides flexibility for QI's to accomplish business combinations or restructurings that may be especially important in the current economic climate.

STATE TAXATION ISSUES

[1] State Income Tax

Under section 1031(h), real property located in the United States and real property located outside the United States are not property of a like kind, and personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind. However, section 1031 imposes no restrictions on exchanges of a property located in one state for a property located in another state. State income tax regimes, even those that conform generally to the Federal income tax, may contain limitations on the availability of nonrecognition treatment for like-kind exchanges. For example, Pennsylvania generally does not allow section 1031 treatment for personal income tax purposes. Several other states impose restrictions such as:

1. requiring that property acquired to replace in-state relinquished property also be in-state property; or

2. purporting to tax nonresidents who have exchanged in-state property for out-of-state property on the gain ultimately recognized on sale of the out-of-state property.

[2] State Transfer Tax

State transfer tax and sales and use tax issues often pose traps for the unwary in connection with multi-party exchanges effected through a QI and in connection with "reverse" exchanges. For Federal income tax purposes, a multi-party exchange effected through a QI is treated as though (1) the taxpayer transferred the relinquished property to the QI, (2) the QI transferred the relinquished property to a third party, (3) a fourth party transferred the replacement property to the QI, and (4) the QI transferred the replacement property to the taxpayer. (If "directed deeds" are used, there may be fewer conveyances of real property, but the exchange agreement between the taxpayer and the QI will still lay out this transaction structure.)

A state might attempt to impose transfer tax on each of the four transfers listed above, resulting in double taxation for each of the relinquished property and replacement property transfers. Similar transfer tax issues arise in the case of "reverse" exchanges. In a reverse exchange, an "EAT" acquires and holds replacement property for a period of time (typically until the taxpayer has disposed of the relinquished property[56]) and then transfers the replacement property to the taxpayer. These multiple transfers of the same property may trigger multiple transfer taxes in some jurisdictions. For instance, Pennsylvania has stated affirmatively that it intends to impose transfer tax on each transfer of the same property in each step of a reverse exchange.[57] Certain states, on the other hand, have exceptions in their transfer tax statutes which are explicitly, or have been interpreted to be, applicable to deferred exchanges and reverse exchanges, and result in an exemption from transfer tax for the second (duplicate) transfer.

CONTRIBUTIONS AND DISTRIBUTIONS OF PROPERTY

The Service has taken the position that nonrecognition treatment under section 1031 may not be available if, for example, the relinquished property has been received by the taxpayer as a distribution from a partnership (or other entity) shortly before the exchange, a partnership (or other entity) distributes the replacement property to a partner (or other equity owner) shortly after the exchange, or the taxpayer contributes the replacement property to a partnership (or other entity) shortly after the exchange. These sorts of transactions are sometimes effected as a means of attempting to enable some partners to take advantage of section 1031 at the same time that other partners "cash out." Although taxpayers have won some notable victories on these issues,[58] the Service has not "thrown in the towel," the law remains unsettled, and there is concern that the Service may challenge such transactions in many circumstances.

[1] Recent PLR's

In a number of recent PLR's, the Service agreed that nonrecognition treatment would be available notwithstanding contributions of relinquished or replacement properties by a testamentary trust to a new LLC succeeding the trust's interest in the properties, or distributions of replacement properties to a beneficiary, when the contributions and distributions were necessitated by the termination of the testamentary trust in accordance with the terms of the decedent's will. See PLR's 200521002, 200528011, 200651030, and 200812012. In each case,

the Service noted that the trust was terminating involuntarily by its own terms without regard to the exchanges at issue and that the exchanges were thus independent from the termination of the trust.

[2] Changes to Form 1065

At the same time, the Service has increased its ability to identify and scrutinize such transactions by adding two questions to Schedule B of Form 1065 (U.S. Return of Partnership Income):

1. Question 13: Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (including a disregarded entity).

2. Question 14: At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?

APPENDIX

On Mach 5, 2010, the Internal Revenue Service issued Revenue Procedure 2010-14, which provides a "safe harbor" method of reporting gain or loss for certain taxpayers who initiate a deferred like kind exchange but fail to complete the exchange solely because of a QI default involving a QI that becomes subject to a bankruptcy proceeding under the United States Code or a receivership proceeding under Federal or State law. Taxpayers who fall within the scope of the Revenue Procedure may report gain realized on the disposition of the relinquished property only when the taxpayer receives payments attributable to the relinquished property. The amount of gain attributable to each payment, and the portion of any payment which represents imputed interest, are computed under formulas provided in the Revenue Procedure. If indebtedness that was assumed or taken subject to by the buyer or satisfied in connection with the transfer of the relinquished property exceeds the adjusted basis of the relinquished property, that excess is considered a payment received in the year of the exchange. Taxpayers falling within the scope of the Revenue Procedure may in some cases be able to claim a loss deduction under section 165.

The Revenue Procedure is effective for taxpayers whose like-kind exchanges fail due to a QI default occurring on or after January 1, 2009. Taxpayers who fall within the scope of the Revenue Procedure may file an original or amended return to report a deferred like-kind exchange that failed due to a QI default in an earlier taxable year in accordance with the Revenue Procedure.

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[1] The author thanks his colleagues Howard J. Levine, Lana A. Kalickstein, and Mark E. Wilensky for their assistance in preparation of this article.

[2] Compare Code section 453(e)(1).

[3] While these examples appear only in the Print prepared by the Senate Finance Committee (and not in the Report of the House Ways and Means Committee), the Conference Committee Report appears to indicate concurrence. S. PRT. NO. 56, 101st Cong., 1st Sess. 151 (1989); H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 613 (1989).

[4] H.R. REP. NO. 247, 101st Cong., 1st Sess. 1339 (1989); . S. PRT. NO. 56, 101st Cong., 1st Sess. 151 (1989).

[5] During the taxable year in issue, Teruya owned 62.5% of the common shares of Times.

[6] See *Teruya*, 124 T.C. at 51 n.10, citing Treasury Regulation section 1.1031(k)-1(g)(4)(i).

[7] It is not entirely clear from the Tax Court's opinion whether there can be any circumstances in which a transaction, when recast as a "direct" exchange with a related party, would have been denied nonrecognition treatment under section 1031(f)(1) (because it would have been described in that provision and no exception would have been applicable), yet one could still find that the structuring of the transaction, as actually implemented through a QI, was not to avoid the purposes of section 1031(f), with the effect that section 1031(f)(4) would not apply.

[8] *Teruya*, 124 T.C. at 55. The Tax Court's "basis shifting" calculation in this case seems to differ from its analysis in *Ocmulgee*, described in Section 1.01[2][c], below, where the Tax Court compared the taxpayer's hypothetical tax liability, had it sold the relinquished property, to the related party's actual tax liability on the sale of that property.

[9] *Ocmulgee*, 132 T.C. at __ n.6.

[10] The PLR states that the "parties agreed that the fair market value of taxpayer's twenty-five percent (25%) interest in Parcel #1 was equal to the fair market value of Parcel #3."

[11] The trust also owned, and sold, a second parcel, not at issue here.

[12] Technically, the niece's interest was held temporarily in the deceased brother's revocable inter vivos trust on account of difficulties involved in dealing with the undivided interests. Under the trust declaration, the deceased brother's interest in the properties was to be distributed outright and free of trust to the niece.

[13] This statement seems incorrect in light of Rev. Rul. 59-171, 1959-1 C.B. 65, and PLR 9017008. Nevertheless, it is comforting to know that the Service conceded that, even if a relationship that did exist, the termination of that relationship at any time prior to the actual implementation of the exchange would suffice to prevent the application of section 1031(f).

[14] The relinquished property was in fact conveyed directly by Taxpayer to the third party buyer, at the Taxpayer's QI's direction. Treasury Regulation section 1.1031(k)-1(g)(4)(iv)(B)-(C), (v) provides that a conveyance pursuant to a directed deed is treated as (1) a conveyance from the grantor to the QI, immediately followed by (2) a conveyance from the QI to the grantee. The summary of the facts of the PLR's provided in text give effect to the notional transactions that are treated as having occurred under the Treasury Regulations.

[15] Taxpayer and the related party may have entered into exchange agreements with the same qualified intermediary. In order to make it easier to follow the transaction steps, our description distinguishes between "Taxpayer's QI" and "related party's QI."

[16] Taxpayer's replacement property was conveyed, at Taxpayer's QI's direction, by the related party's QI directly to Taxpayer.

[17] The related party's replacement property was conveyed, at the related party's QI's direction, by the former owner of that property directly to the related party.

[18] PLR 200616005 did contain a favorable ruling on the related party's exchange as well.

[19] The later PLR's recite as facts that the amount of boot will not exceed a stated percentage -- redacted in the released versions of the PLR's -- of the gain realized.

[20] The unrelated party would have sold Taxpayer's relinquished property to the TRS following the exchange.

[21] For a similar holding, see PLR 200712013.

[22] These types of property were not divided into "classes" because of their great variety and the lack of generally available classification systems. See Notice of Proposed Rulemaking, Like-Kind Exchanges – Additional Rules for Exchanges of Personal Property and for Exchanges of Multiple Properties (IA-12-89), 1990-1 C.B. 654, 655.

[23] Treasury Regulation section 1.1031(a)-2(c)(3).

[24] *Compare* PLR 200823014, in which a REIT, which owned and managed community and neighborhood shopping centers, sold part of its business. A portion of the purchase price was allocated to goodwill generated by the business. The Service held that, for purposes of determining qualification of income under the REIT income tests in Code section 856, the gain attributable to disposition of the goodwill could be characterized in the same manner as the income produced by the REIT's activities in the trade or business to which the goodwill related. Under the rationale of this PLR, one could make an argument that, when businesses to which exchanged goodwill relates are of like kind, the exchange of goodwill should be permitted to qualify under section 1031.

[25] Treasury Regulation section 1.1031(j)-1 contains rules for exchanges of multiple properties, under which taxpayers are generally permitted to "match up" relinquished properties and replacement properties that are of like-kind in a way that minimizes that amount of gain that is required to be recognized.

[26] The Service's position in the TAM with respect to trademarks and trade names, that such items were inseparable from goodwill, meant that the test for intangibles was inapplicable to these items.

[27] Section 1031(h)(2)(A) provides that personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind.

[28] The Service also rejected the identifications for failure to comply with requirements regarding the number and/or value of properties permitted to be identified. The Service stated that the "Taxpayer identified as replacement property the intangible assets of more than three companies (violating the 'three property rule'), identified replacement property having a fair market value in excess of 200 percent of the value of the relinquished property (violating the '200-percent rule'), and acquired less than 95 percent of the aggregate fair market value of the all the identified replacement property (violating the '95-percent rule')."

[29] Code section 197, allowing the amortization of purchased goodwill, was not in effect for the years involved in the case.

[30] In *Crichton v. Commissioner*, 122 F.2d 181 (5th Cir. 1941), the Court of Appeals stated:

For the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized [*sic*] by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use.

[31] However, the Service also cited to Revenue Ruling 55-749, in which the Service had looked to both state law and Federal law to determine like-kind characterization. In Revenue Ruling 55-749, the Service stated that the fact that the two varieties of property being exchanged may be legally classified under state law as real property "does not of itself signify that the two are property of like nature or character within the meaning of section 1031(a). If there be substantial difference in the rights created in and to the respective properties, then the properties are not of like kind."

[32] In a footnote, the Service contrasted the case where a right or interest arising out of real estate is for a term of something less than in perpetuity (or for less than thirty years in the case of a land lease) and where the interest is defined in terms of a specific sum of money, in which case the interest would not be deemed of like kind to a fee interest in real property.

[33] See, e.g., *Oregon Lumber Co. v. Commissioner*, 20 T.C. 192 (1953), where the Taxpayer exchanged a fee simple interest in real property for a limited right to cut and remove standing timber. The Tax Court found that the cutting rights were personal property under state law and held that an exchange "of realty for personalty is not an exchange of property for property of like kind."

[34] See Kelly E. Alton & Louis S. Weller, *Does State Law Really Determine Whether Property is Real Estate for Section 1031 Purposes?*, 32 REAL ESTATE TAXATION 30, 36-37 (2004).

[35] See *Peabody*, 126 T.C. at 275 n.11.

[36] See Treasury Regulation section 1.1002-1(d).

[37] *Pembroke v. Helvering*, 70 F.2d 850 (D.C. Cir. 1934), *aff'g* 23 B.T.A. 1176 (1931) (Court of Appeals affirmed Board of Tax Appeal's holding that Taxpayer's leasing of its premises to third party tenant, in exchange for cash rental payments and fee interest in a different real estate parcel, was not a like-kind exchange; cash rent payments and transfer of the fee interest in the real estate parcel were treated as rental payments and were taxable as ordinary income; grant of a lease by the taxpayer/property owner not a transfer of property that is eligible for like-kind exchange treatment). However, Taxpayer's disposition of a leasehold interest in property owned by another person and leased to the taxpayer may constitute an exchange. See PLR 200842109, discussed in footnote 41, below.

[38] The cash and old plant were consideration paid to the contractor for its services in construction of the new plant on the taxpayer's land.

[39] Revenue Ruling 68-394 addressed whether the property acquired by the taxpayer with involuntary conversion proceeds qualified under section 1033(g), which incorporates the "like-kind" standard of section 1031.

[40] In PLR 200901020, the Service permitted a taxpayer to exchange residential density development rights for hotel development rights to be applied to property already owned by the taxpayer, a fee interest in land, and a long-term leasehold interest in other property.

[41] Fact Sheet on Like-Kind Exchanges Under IRC Code Section 1031, FS-2008-18, February, 2008 [http://www.irs.gov/newsroom/article/0,,id=179801,00.html]. *See also* Revenue 67-255, 1967-2 C.B. 270, where the Service held that the investment of condemnation proceeds from an involuntary conversion of land held for investment in the construction of an office building or, alternatively, storm drains, water systems, and roads upon land already owned by Taxpayer did not qualify as a "like-kind" replacement of the converted property for purposes of Code section 1033(g).

[42] In PLR 200842019, Taxpayer transferred his leasehold interest, including tax ownership of certain improvements, in exchange for a new lease on a new building, which included improvements to be constructed for the exchange. The Service concluded this was a good exchange. The Service did not discuss the significance of Taxpayer's being treated as the owner of the improvements for tax purposes and did not require any allocation of the exchange proceeds between the improvements and the amount allocable to the ground lease.

[43]See, e.g., Revenue Ruling 66-209, 1966-2 C.B. 299, providing that "the transfer of real property in consideration of the execution of a leasehold interest in the same or other property may be an exchange of properties of like kind for purposes of section 1031 of the Code to the transferor-lessee."

[44] The QI may not be the taxpayer or a "disqualified person." *See* Section 1.04[3][a], below.

[45] In exchanges (including "reverse exchanges") involving the use of an "exchange accommodation titleholder" (or "EAT") under Revenue Procedure 2000-37, the EAT will, as the term suggests, take and hold title to property for some period of time.

[46] The LandAmerica bankruptcy opinion, *In Re: LandAmerica Financial Group Inc.*, No. 08-35994-KRH (Bankr. E.D. Va., April 15, 2009), Joint Motion Pursuant to Rule 9019, APN 08-03149, indicates that some of the exchange agreements used by LandAmerica provided for taxpayers' sales proceeds to be held in segregated accounts, all of which were, however, found to be part of the QI's bankruptcy estate. It appears that qualified trusts were not used in that case, so one can still hope that the funds in such a trust (assuming that the QI did not misappropriate them) would be found to be outside of a QI's bankruptcy estate and to be payable in full to the taxpayer.

[47] After this article was submitted, the Service issued Revenue Procedure 2010-14, which provides a safe harbor method of reporting gain or loss for certain taxpayers who do not complete a deferred exchange because of a QI default. Please see the Appendix to this article for a brief description of the Revenue Procedure. The discussion in this section remains relevant for taxpayers who either do not fall within the scope of the Revenue Procedure or do not wish to report gain or loss from a failed deferred exchange in accordance with it.

[48] Some of the Service's letters, described below, create uncertainty whether the taxpayer's realized gain includes amounts received and misappropriated by the QI. See, e.g., INFO 2009-063 and INFO 2009-066, where Associate Chief Counsel stated, "The taxpayer must currently recognize and report in income any gain realized on the disposition of the relinquished property through the QI." Associate Chief Counsel also noted that any loss by the taxpayer would but not be sustained for tax purposes until the year "that it is evidenced by closed and completed transactions and fixed by identifiable events occurring in that taxable year," citing Treas. Reg. § 1.165-1(d).

[49] The Ways and Means Committee does not appear to have taken any action on this bill.

[50] Treasury Regulation section 1.7872-16(d) provides for interest at the Federal short-term rate, if lower than the interest rate on a 13-week Treasury bill.

[51] Treasury Regulation section 1.7872-5(a)(2) states that the $2 million exemption will not apply if the taxpayer structured a transaction to be a loan for less than $2 million and one of the principal purposes therefor was the avoidance of Federal tax.

[52] The earnings attributable to the exchange funds includes only the earnings credited to the taxpayer's account or paid to the taxpayer, and not any income received by the depository institution from investment of the exchange funds in its ordinary course of business of investing customer deposits.

[53] Section 1.1031(k)-1(k)(4)(i). Persons "related" to the taxpayer are also "disqualified persons."

[54] One might also be uncertain regarding whether there had been an "exchange," as the taxpayer would be considered to have transferred property to one party and to have received property from a different party.

[55] *Compare* Revenue Ruling 2004-86, in which the Service treated an interest in a Delaware Statutory Trust which owned real property as an interest in the underlying real property, notwithstanding the Trust's independent significance for state law purposes. The Service ignored the state law characterization of the replacement property as an interest in a trust. *See also* PLR 200709013, in which the Service held that a change in the Federal tax classification of the issuer of a debt instrument from an association taxable as a corporation to a wholly owned limited liability company disregarded for Federal income tax purposes, subsequent change from a disregarded entity to a partnership for Federal income tax purposes, and subsequent technical termination of the partnership under section 708(b)(1)(B) is not a substitution of a new obligor resulting in a "significant modification" for purposes of Treasury Regulation section 1.1001-3.

[56] An "EAT" may also hold the replacement property for a period of time after the taxpayer has disposed of the relinquished property if the taxpayer desires to treat improvements that are being constructed on the replacement property as property received in the exchange.

[57] *See, e.g.,* PIT Bulletin 2006-07, Pennsylvania Department of Revenue (October 20, 2006).

[58] *See, e.g.*, *Magneson v. Commissioner*, 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985) (exchange qualified for nonrecognition treatment where the taxpayer, pursuant to a plan, exchanged a fee interest in real estate for an undivided interest in replacement property, and thereafter contributed the undivided interest to a limited partnership in exchange for a general partnership interest therein); *Bolker v. Commissioner*, 81 T.C. 782 (1983), *aff'd*, 760 F.2d 1039 (9th Cir. 1985) (exchange qualified for nonrecognition treatment where the taxpayer, pursuant to a plan, caused his wholly-owned corporation to make a liquidating distribution to him of a fee interest in real property under section 333 of the pre-1986 Code, and thereafter exchanged the property for interests in other real property).