NEW RULINGS ENHANCE PLANNING OPPORTUNITIES FOR LIKE KIND EXCHANGES

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Several recent private letter rulings have confirmed the parameters for an interesting tax planning opportunity involving related parties engaged in a like kind exchange. The technique allows a taxpayer who wants to dispose of a property to purchase the replacement property from a related party, which may be helpful in situations where the taxpayer has trouble finding acceptable replacement property within the time frames required by I.R.C. § 1031. In addition, the technique essentially allows basis to be shifted from one property to another property among related parties. This may be useful where a taxpayer wishes to dispose of a low-basis property. By exchanging that property with a high-basis property owned by a related party, the related group can ultimately sell the property they wish to dispose of, but that property will carry the high-basis upon its disposition.

Related party exchanges are generally governed by I.R.C. § 1031(f), which provides that if a taxpayer engages in an exchange which otherwise qualifies under § 1031 with a related party[1], gain will have to be recognized if either the taxpayer or the related party disposes of the property received in the exchange within two years of the exchange.[2] The concern in many of these transactions is I.R.C. § 1031(f)(4), which states that I.R.C. § 1031 will not apply to any transaction or series of transactions structured to avoid the purpose of § 1031(f). However, the two-year period in § 1031(f) is essentially treated like a safe harbor. In FSA 200137003, where related parties engaged in a like kind exchange, and one of the parties disposed of its property received in the exchange more than two years after the original exchange, the Service stated:

> We believe that the two-year rule in section 1031(f)(1)(C) is a safe harbor that precludes application of section 1031(f)(1) to any transaction falling outside that period. Thus, a taxpayer acquiring property from a related party can avoid application of the rule in section 1031(f)(1) merely by waiting until after the two year period to dispose of the property.
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> Therefore, I.R.C. section 1031(f)(4) does not apply to this situation because there was no attempt by either party to circumvent the rules. Rather, the parties merely took advantage of what Congress allowed them by enacting the two-year rule.

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[1] Related person for this purpose is defined in I.R.C. § 1031(f)(3) as any person bearing a relationship to the taxpayer described in I.R.C. § 267(b) or § 707(b)(1).

[2] Certain dispositions within two years will not trigger gain recognition, such as a disposition due to death or involuntary conversion, or where it is established to the satisfaction of the Secretary that neither the exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax. See I.R.C. § 1031(f)(2).

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Gregory v. Helvering, 293 U.S. 465, 469 (1935). In our view, the purpose of section 1031(f)(4) is to stop taxpayers from violating the two-year rule, and not to preclude taxpayers from planning to dispose of property after the two-year period. Thus, if a taxpayer exchanges property with a related party, intending to dispose of the replacement property after the two-year period, section 1031(f)(4) would not require recognition of the original gain. This analysis would not apply, however, if the exchange were a sham.

A similar technique was recently used in identical private letter rulings: PLR 200810016 and PLR 200810017. In those rulings, the AB LLC ("AB"), which owned Blackacre, and the CD LLC ("CD"), which owned Greenacre, were related parties. AB agreed to sell Blackacre to an unrelated buyer ("Buyer"), and wanted to do so as part of a § 1031 exchange by acquiring Greenacre as its replacement property. CD will acquire qualified replacement property so that its transfer of Greenacre will also qualify under § 1031. To facilitate their exchanges, AB and CD enter into exchange agreements with a qualified intermediary ("QI").[3] Pursuant to the exchange, AB will transfer Blackacre to QI, QI will sell Blackacre to Buyer, acquire Greenacre from CD, and transfer Greenacre to AB to complete AB's exchange. Similarly, QI will receive Greenacre as part of CD's like kind exchange, will acquire New Property from an unrelated Seller and transfer it to CD to complete CD's exchange. After all of the transactions are completed, Buyer will own Blackacre, AB will own Greenacre, and CD will own New Property. AB and CD agree not to dispose of their respective properties within two years of the exchange.

Note first of all that had AB and CD simply exchanged Blackacre for Greenacre and then CD sold Blackacre to Buyer, AB would not be entitled to nonrecognition because the related party (CD) disposed of the exchanged property within two years of the exchange.[4] Assume for example that CD had just purchased Greenacre for $100 and so had a $100 basis and value in Greenacre, and assume that AB's basis in Blackacre was $10 while its value was $100. After the exchange, AB would hold Greenacre with a $10 basis[5] and CD would hold Blackacre with a $100 basis. If the goal of the parties was to ultimately sell Blackacre (which had $90 of gain in AB's hands), Blackacre could now be sold by CD for no gain ($100 value with a substituted $100 basis).[6] However, since § 1031(f) essentially views the related parties as one person, the taxpayer is cashing out his or her investment, which is contrary to the purpose of § 1031, and AB's exchange would not be a nonrecognition transaction.[7] AB and CD could of course have done a direct exchange

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[3] See Treas. Reg. § 1.1031(k)-1(g)(4).

[4] I.R.C. § 1031(f). Likewise, simply putting a QI in the middle will not solve the problem. See Rev. Rul. 2002-83, 2002-2 C.B. 927.

[5] See I.R.C. § 1031(d).

[6] Although even in the absence of § 1031(f), CD is unlikely to satisfy the "held for" requirement of § 1031, CD does not need a nonrecognition exchange where there is no gain in Greenacre.

[7] Both the Ways and Means Committee Report and the Senate Finance Committee Print, describe the policy concern that led to enactment of § 1031(f): "Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind

of Blackacre for Greenacre and waited two years to sell Blackacre, but Buyer may not be willing to wait two years to acquire Blackacre.

Consequently, in PLR 200810016 and PLR 200810017, the parties wanted to sell Blackacre to Buyer, but a simple exchange for Greenacre and subsequent sale for cash would have violated § 1031(f), since one of the related parties cashed out their investment. However, the Service in PLRs 200810016 and 200810017 ruled that § 1031(f) did not apply to the transaction described above since:

> the only subsequent disposition of replacement property contemplated by the parties is the use of the proceeds from the disposition of Greenacre by CD to acquire CD's replacement property in another exchange under § 1031, a nonrecognition transaction. Therefore, § 1031(f)(4) will not apply to require recognition of gain or loss in the exchanges of either related party. Both AB's exchange and CD's exchange are structured as like-kind exchanges qualifying under § 1031. There is no "cashing out" of either party's investment in real estate. Upon completion of the series of transactions, both related parties will own property that is of like kind to the property they exchange. Neither exchanger will receive cash or other non-like-kind property (other than some possible boot) in return for the relinquished property.

Using related parties in like kind exchanges can be helpful in locating acceptable replacement property and shifting basis from a high-basis property to a low-basis property. However, taxpayers must structure their exchange to either wait two years to cash out their investment, or sell the desired relinquished property in another qualified exchange.

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exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989); S. Print No. 56, at 151.