FAVORABLE IRS RULINGS ON RELATED-PARTY EXCHANGES IMPLICITLY CLARIFY SOME ISSUES

BY RICHARD M. LIPTON

In three recent letter rulings, the Service did not apply the related-party rules that accelerate gain recognition if the related party disposes of the property within two years of the exchange transaction. IRS found there was no basis shifting, and therefore no reason to apply the anti-abuse rule in Section 1031(f)(4). Moreover, the QI involved was not viewed as the taxpayer's agent for Section 1031(f)(4) purposes, resolving an open question.

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In three private rulings published within a six-week period, the IRS recently clarified the scope of the restrictions on related-party exchanges under Section 1031(f). These rulings will make it easier for a taxpayer to exchange property with a related party—and then have the related party sell the property received in the exchange—when the exchange does not result in basis-swapping. In one other recent ruling on a so-called "drop and swap" transaction, the IRS provided a favorable answer but left open many questions.

BACKGROUND

Section 1031(a)(1) generally provides that no gain or loss is to 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 that is to be held either for productive use in a trade or business or for investment.

There are limitations on related-party exchanges. Under Section 1031(f)(1), if (1) a taxpayer exchanges property with a related person, (2) nonrecognition treatment otherwise would apply to such exchange under Section 1031(a), and (3) within two years of the date of the last transfer either the taxpayer or the related person disposes of the property received in the exchange, then there is no nonrecognition of gain or loss on the initial exchange.[1] That is, the gain or loss that was deferred under Section 1031(a) must be recognized as of the date of the disposition of the property received in the exchange.

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of Section 1031(f)(1). These include any disposition (1) after the earlier of the death of the taxpayer or the death of a related person, (2) in a compulsory or involuntary conversion (within the meaning of Section 1033) if the exchange occurred before the threat or imminence of such conversion, or (3) with respect to which it is established to the Service's satisfaction that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax.

In addition, Section 1031(f)(4) provides that Section 1031(a) will not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). Thus, if a transaction is set up to avoid the restrictions of Section 1031(f), Section 1031(f)(4) operates to prevent the nonrecognition of gain or loss in such exchange.

The purpose underlying Sections 1031(f)(1) and (f)(4) was clearly laid out in the legislative history: "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 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 acceler-

ate 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....

The nonrecognition rules will not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f).

"Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031."[2]

The related-party rules are then subject to an "overlay" as a result of the operational aspects of the Regulations under Section 1031. The most important of these rules allows taxpayers to use a qualified intermediary (QI) to facilitate a three-party like-kind exchange. Under Reg. 1.1031(k)-1(g)(4), a taxpayer's transfer of relinquished property to a QI, and the subsequent receipt of cash by the QI on the sale of the relinquished property, is not treated as constructive receipt of such cash by the taxpayer. Instead, provided that the taxpayer timely receives like-kind replacement property from the QI, the transaction is treated as an exchange with the QI for purposes of Section 1031(a).

This rule is used primarily with respect to deferred exchanges. In such an exchange, a taxpayer who has transferred relinquished property must identify replacement property within 45 days and close on the purchase of the replacement property within 180 days of the sale of the relinquished property. Nevertheless, the QI deferred exchange Regulation generally provides a "substantive" rule that the exchange at issue is viewed as occurring between the taxpayer and the QI (and is not an exchange involving multiple parties).

Although the role of the QI is generally respected for purposes of Section 1031, the presence of a QI in a transaction is not sufficient to prevent the application of Section 1031(f)(4). The IRS emphasized this result in Rev. Rul. 2002-83, 2002-2 CB 927. In that Ruling, Terry owned real property (property 1) with an FMV of $150 and an adjusted basis of $50. Lou owned real property (property 2) with an FMV of $150 and an adjusted basis of $150. Both property 1 and property 2 were held for investment, and Terry and Lou were related persons. David, an individual unrelated to Terry and Lou, wished to acquire property 1 from Terry. Terry entered into an agreement for the transfers of properties 1 and 2 with Lou, David, and a QI. Pursuant to their agreement, on 1/6/03 Terry transferred property 1 to the QI and the QI transferred property 1 to David in exchange for $150 in cash. On 1/13/03, the QI acquired property 2 from Lou, paid to Lou the $150 sale proceeds from the QI's sale of property 1, and transferred property 2 to Terry.

In the ruling, which is somewhat similar to the facts in *Teruya Bros., Ltd.*, 124 TC 45 (2005),[3] the taxpayer would have argued that there was no violation of Section 1031(f)(1) because there was no sale of relinquished property by Lou to Terry. Furthermore, this fact pattern does not squarely fit within the language of the legislative history of Section 1031(f)(4), because there was no exchange between an unrelated party and a party related to the taxpayer.

Before the transactions occurred, however, Lou and Terry (if viewed as a single person) owned a low-basis property and a high-basis property and no cash, and after the transaction they owned a low-basis property and cash. Thus, the economic effect of this transaction is that Lou engaged in a series of transactions in which (1) low-basis property (property 1) is disposed of, (2) high-basis property (property 2) is transferred from one related party to another, and (3) one of the related parties (in this instance, Lou) received cash without gain recognition.

Section 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. The transaction in Rev. Rul. 2002-83 reached that economic result and the IRS concluded that Section 1031(f)(4) applied.

LTR. RUL. 200706001

The first private ruling in the new trilogy addressed a familial situation involving a taxpayer, the taxpayer's three siblings, and a family trust. During his lifetime, the taxpayer's father had acquired certain timberlands, including parcels 1, 2, and 3, all of which were held for investment. After the father's death, parcel 1 was transferred to taxpayer's mother, and parcels 2 and 3 were transferred to a trust that held the parcels for the benefit of the taxpayer's mother during her lifetime, with the taxpayer and her siblings being equal remainder beneficiaries of the trust. Subsequently, the mother transferred parcel 1, as a gift, to the taxpayer and her siblings as tenants-in-common. The per-acre tax basis of all three parcels was the same, reflecting the step-up in basis that occurred on the death of the taxpayer's father.

The trustees of the trust and the taxpayer's siblings decided to sell all of their land holdings, including parcels 1, 2, and 3, but the taxpayer did not

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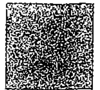
1 Section 1031(f)(3) defines a "related person" as any person bearing a relationship to the taxpayer described in Section 267(b) or 707(b)(1).

2 H. Rep't No. 101-247, 101st Cong., 1st Sess. 1340 (1989).

3 See also Lipton, "'The State of the Art' in Like-Kind Exchanges, 2006" 104 JTAX 138 (March 2006); Cuff, "*Teruya Brothers* and Related Party Exchanges—How Much More Do We Know Now?," 102 JTAX 220 (April 2005).



want to sell. To address this situation, the parties agreed that the taxpayer would exchange her undivided 25% fractional interest in parcel 1 for the unencumbered fee simple interest in parcel 3. Rev. Rul. 73-476, 1973-2 CB 312, provides that exchange of an undivided interest in real estate for 100% ownership of one or more parcels of the same real estate qualifies as a valid like-kind exchange. The parties agreed that the FMV of taxpayer's 25% interest in parcel 1 was equal to the FMV of parcel 3. Shortly after the exchange, the trust and the siblings sold parcels 1 and 2 to an unrelated party.

The related-party rules are subject to an 'overlay' as a result of the operational aspects of the Regulations under Section 1031.

At first blush, Section 1031(f)(1) appears to be applicable here because the taxpayer exchanged her interest in parcel 1 for parcel 3 with a related party, and the related party then sold parcel 1. This exchange met the literal terms of the statutory language. Nevertheless, there was no shifting of basis in this transaction because the per-acre basis of all of the parcels was the same (due to the step-up that had occurred on the father's death), so that the siblings recognized the same amount of gain on the sale that they would have recognized if the like-kind exchange had not occurred. Because the transaction did not involve basis shifting, the IRS concluded that Section 1031(f)(2)(C) applied, so that the like-kind exchange was given effect.

The most important aspect of Ltr. Rul. 200706001 may be that the IRS did not rigidly apply Section 1031(f)(1) when there was an exchange of property between related parties, and one of the properties was then disposed of. Instead, the IRS looked at the purpose behind this provision, as well as the discretionary exception provided in Section 1031(f)(2)(C), and concluded that because there was no basis shifting, Section 1031(f)(1) did not apply.

LTR. RUL. 200709036

The second private ruling involved a taxpayer that was an LLC taxable as a partnership. The taxpayer was related to a real estate investment trust (REIT), which was the sole general partner and a 90% owner of an operating partnership (OP) that, in turn, owned 99% of the taxpayer and was the managing member of the taxpayer. Thus, there was no question that the taxpayer, the OP, and the REIT were related parties.

The taxpayer owned multiple parcels of property through separate LLCs and partnerships, including property D, which was owned through Property D LLC, a disregarded entity. Property D was substantially appreciated and had been held by the taxpayer for more than two years in its business of leasing space to tenants.

In the transaction, the taxpayer transferred all of its membership interests in Property D LLC to a related party, a taxable REIT subsidiary (TRS) owned by OP (Buyer TRS). The taxpayer entered into an agreement with an unrelated QI under which the taxpayer assigned to the QI its rights to receive all proceeds payable by Buyer TRS. The taxpayer then identified replacement property owned by an unrelated person within 45 days, and directed the QI within 180 days to acquire the replacement property (using the funds provided by Buyer TRS) and transfer the replacement property to the taxpayer. Buyer TRS anticipated selling some or all of the property acquired from the taxpayer within two years.

Again, at first blush, this transaction could be viewed as triggering the application of Section 1031(f)(1) because the taxpayer sold property to a related party (Buyer TRS), and the related party anticipated that the property would be sold within two years. The IRS concluded, however, that the taxpayer had not exchanged property with Buyer TRS but, rather, the taxpayer had exchanged property with the QI, which was not a related person. Therefore, on its face, Section 1031(f)(1) was not applicable, because there was no exchange between related persons.

The question, therefore, was whether the transaction was subject to the anti-abuse rule in Section 1031(f)(4). This provision would apply if the taxpayer and Buyer TRS could be viewed as exchanging properties either directly or through the QI and the result of the exchange was contrary to the purposes of Section 1031(f)(1). Nevertheless, Buyer TRS did not own, prior to the exchange, any property that the taxpayer acquired, so there could not have been an exchange between the taxpayer and Buyer TRS.

The most important aspect of Ltr. Rul. 200706001 may be that the IRS did not rigidly apply Section 1031(f)(1).

Furthermore, because Buyer TRS did not own any property prior to the exchange, it was not possible for the taxpayer and a related person to engage in a basis swap—there was no property held by a related party that had a basis to swap. Rather, prior to the exchange, the taxpayer owned property D, which Buyer TRS acquired by purchasing it for its FMV from the QI. Thus, there was no transaction that was structured to avoid the purposes of Section 1031(f)(1), so Section 1031(f)(4) did not apply. The subsequent sale of property D did not trigger gain recognition to the taxpayer because Section 1031(f)(1) had never applied.

The Service based its conclusion on the legislative history of Section 1031(f)(4) quoted above. Specifically, the IRS stated that Section 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high-basis property for low-basis property in anticipation of the sale of the low-basis property. In such circumstances, the original exchange should not be accorded nonrecognition treatment. Where only one of the related parties owns property that is exchanged, however, Section 1031(f)(4) did not apply.

Although the IRS did not do so in the ruling, it also is helpful to consider

the flow of money in this transaction, which indicates situations in which Section 1031(f)(4) should apply. In Ltr. Rul. 200709036, prior to the transaction, the taxpayer owned property D, which presumably had a low basis, and Buyer TRS had cash. After the sale of property D to Buyer TRS, and the purchase of replacement property (from a third party) through the QI, the taxpayer owned only replacement property acquired from an unrelated person, which had a low basis in the taxpayer's hands, something the taxpayer was always allowed to do under Section 1031. Buyer TRS, on the other hand, had cash before the transaction (which it used to purchase property D) and, after the sale of property D at some future time, also had cash. Thus, there was no basis shifting (as in Rev. Rul. 2002-83) or "cashing out," in which one of the related parties who previously owned property received cash on the sale of low-basis property without gain recognition.

LTR. RUL. 200712013

The final installment in this trilogy of rulings involved a situation in which the taxpayer owned a property (Blackacre) that had appreciated substantially in value. A party related to the taxpayer wanted to acquire Blackacre, and the taxpayer wished to transfer Blackacre to the related party in a like-kind exchange. Because the related party did not own any like-kind assets that the taxpayer wished to acquire, the taxpayer entered into an agreement with an unrelated third party under which the third party agreed to sell a replacement property, Whiteacre, to the taxpayer. The replacement property was acquired by the taxpayer using a "reverse exchange" under Rev. Proc 2000-37, 2000-2 CB 308, in which the taxpayer provided all of the funds needed by an exchange accommodation titleholder (an EAT) to acquire Whiteacre.[4]

After the taxpayer had funded the acquisition of Whiteacre through the EAT, the taxpayer entered into an agreement with the related party pursuant to which the taxpayer agreed to transfer Blackacre to the related party in exchange for cash. The taxpayer then assigned its sale contract to a QI, which transferred Blackacre to the related party for cash and then used the cash to complete the reverse exchange for Whiteacre. Thus, when the dust settled, the taxpayer owned Whiteacre with a carryover basis and the related party owned Blackacre with a basis equal to its FMV. The related party stated that it intended to dispose of Blackacre within two years.

There was no transaction that was structured to avoid the purposes of Section 1031(f)(1), so Section 1031(f)(4) did not apply.

The IRS accepted the taxpayer's representations in its ruling request that acquisition of Whiteacre through a reverse exchange under Rev. Proc. 2000-37, as well as the disposition of Blackacre through a forward exchange with the related party, ostensibly satisfied the requirements of Section 1031(a). Accordingly, the IRS viewed the issue as whether nonrecognition treatment would apply to a transaction where (1) the taxpayer purchased like-kind replacement property from an unrelated third party via an EAT, (2) the taxpayer sold relinquished property to a related party for cash (through a QI), and (3) the related party then disposed of the relinquished property within two years of the acquisition.

The IRS concluded, first, that Section 1031(f)(1) was not applicable in this situation because the taxpayer and the related party did not enter into an exchange. Instead, taxpayer transferred the relinquished property (Blackacre) to the QI, which also transferred the replacement property (Whiteacre) to the taxpayer through the reverse exchange. Thus, the exchange was treated as occurring between the taxpayer and the QI, who were not related parties.

The more important question was whether Section 1031(f)(4) would apply in this situation, as it had in Rev. Rul. 2002-83. Again, the IRS concluded that Section 1031(f)(4) was inapplicable. Specifically, the IRS stated that the taxpayer did not transfer Blackacre to a related party as part of a transaction or series of transactions structured to avoid the purposes of Section 1031(f)(1). The related parties in this transaction did not exchange high-basis property for low-basis property in anticipation of the sale of the low-basis property. Only the taxpayer held property before the reverse like-kind exchange, and the taxpayer continued to hold like-kind property after the exchange. The related party did not hold property before the exchange, so there was no "shifting" of the basis of property between the taxpayer and the related party. As a result, the sale of Blackacre by the related party did not trigger gain recognition.

This situation needs to be distinguished from Rev. Rul. 2002-83, in which immediately before the exchange the related party held high-basis property and the taxpayer held low-basis property. Technically Section 1031(f)(1) did not apply in that ruling, either, because the taxpayer exchanged with the QI rather than the related party. Nevertheless, because the related party disposed of the property it acquired from the taxpayer, the effect of the transaction in the Revenue Ruling was that basis was "shifted" from the high-basis property owned by the related party to the low-basis property formerly owned by the taxpayer. As a result, Section 1031(f)(4) applied in Rev. Rul. 2002-83 but not in this situation.

Moreover, in Rev. Rul. 2002-83, collectively the related parties engineered a transaction in which the low-basis property was sold, the high-basis property previously owned by a related party was retained, and the related parties ended up holding cash (that they did not previously have) and not having gain recognition. This was effectively the same transaction as described in Section 1031(f)(1), except that the order of the steps was reversed.

By contrast, in Ltr. Rul. 200712013, while the low-basis property held by the taxpayer was sold, there was no

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4 For a discussion of reverse exchanges, see Lipton, *supra* note 3.

high-basis property owned by a related party prior to the exchange. All that happened in substance in the letter ruling was that the taxpayer sold its property (Blackacre) and acquired replacement property (Whiteacre) from an unrelated person. The transfer of Blackacre to a related party did not alter the underlying economics, in that there was no "cashing out" in the transaction with respect to low-basis property. Specifically, Buyer TRS had cash before it acquired Blackacre, and it had cash again when Blackacre was sold, so there was no utilization of high-basis property in order to obtain cash on the sale of low-basis property.

ANALYSIS OF THE RELATED-PARTY RULINGS

In all three of the rulings concerned with related-party involvement in Section 1031 exchanges, it appears that the IRS reached the correct conclusion. Moreover, the Service did not apply Section 1031(f)(4) in situations in which there was no basis shifting between high-basis property and low-basis property. Instead, the IRS limited the application of Section 1031(f)(4) (and Rev. Rul. 2002-83) to situations in which related parties, either directly or through a QI, used an exchange of high-basis property for low-basis property to obtain the benefit of the high basis on a cash sale of the low-basis property. This limitation appears to be appropriate, but prior to these rulings it was unclear whether the IRS would so limit the application of Section 1031(f)(4).

The ruling trilogy also implicitly indicates the importance of considering the "cash aspects" of a transaction and a "before-and-after" analysis. As discussed above, these rulings can best be distinguished from Rev. Rul. 2002-83 by looking at the parties' situations before and after the exchange. In Rev. Rul. 2002-83, if the related parties are viewed as a single person, before the exchanges at issue the related parties had high-basis property and low-basis property and no cash, whereas after the exchange the related parties held the high-basis property (now with a low basis) and cash. This is the same result that occurs in a transaction described in Section 1031(f)(1). In contrast, in the rulings where Section 1031(f)(4) was not applied, before the exchange the related parties held low-basis property and cash, and after the exchange the related parties held low-basis property (acquired from a third party) and cash. Thus, their collective situation was not altered by the exchanges, which is consistent with the purpose underlying Section 1031(a).

An even more important aspect of the three rulings, including particularly the last two rulings, is that the Service took the QI into account in applying Section 1031(f)(4). Prior to these rulings, there was some question whether a QI would simply be viewed as an "agent of the taxpayer" for purposes of Section 1031(f)(1) even if the QI was not viewed as the taxpayer's agent for purposes of determining whether the taxpayer was in constructive receipt of the proceeds of a sale. As a result of these rulings, it is clear that the QI will be viewed as a person unrelated to the taxpayer for purposes of determining whether a taxpayer has entered into an exchange with a related party. Thus, transactions involving a QI will not be subject to Section 1031(f)(1) by its literal terms.

The transfer of Blackacre to a related party did not alter the underlying economics, in that there was no 'cashing out' in the transaction with respect to low-basis property.

This does not mean, however, that such transactions cannot be challenged under Section 1031(f)(4). Rev. Rul. 2002-83 makes it clear that any transaction which results in basis shifting between related parties, whether directly or through a QI, will be subject to challenge. On the other hand, if neither of the related parties owns high-basis property which is retained as part of the transaction, and if there is no "cashing out" as part of the transaction, these rulings clarify that Section 1031(f)(4) will not be applicable.

Practice Notes

The new ruling trilogy involving related-party exchanges implicitly indicates the importance of considering the "cash aspects" of a transaction and the benefits of a "before-and-after" analysis as the best way to distinguish Rev. Rul. 2002-83.

A DROP AND SWAP RULING

One other recent pronouncement from the IRS, Ltr. Rul. 200651030, addressed a so-called "drop and swap" transaction, in which a transfer of property to a partnership is followed by a like-kind exchange. This ruling may be more noteworthy for the authorities that it distinguished, as well as those it ignored, rather than for its conclusion.

In Ltr. Rul. 200651030, a trust was established by a decedent for the benefit of his wife and daughters. The trust owned two properties, Greenacre and Yellowacre. As part of a plan involving the termination of the trust, certain assets of the trust were contributed to a single-member LLC owned by the trust. The trust then entered into a contract to sell Greenacre in a like-kind exchange, and transferred the contract of sale to the LLC. The same process was then repeated with respect to Yellowacre. The interests in the LLC were then distributed by the trust to its beneficiaries, with the closing on the sales of Greenacre and Yellowacre occurring shortly after the LLC became a multi-member entity. The LLC then sold the two properties, which were replaced by Blueacre and Redacre, respectively. The issue was whether there was a good like-kind exchange when the relinquished properties (Greenacre and Yellowacre) were transferred by the trust to the LLC immediately prior to the like-kind exchange.

In Rev. Rul. 75-292, 1975-2 CB 333, an individual taxpayer in a prearranged transaction transferred land and buildings used in the taxpayer's

trade or business to an unrelated corporation in exchange for land and an office building owned by the corporation and used in its trade or business. Immediately thereafter, the individual taxpayer transferred the land and office building to the individual's newly created corporation in exchange for the stock of the corporation. The Revenue Ruling concluded that the individual taxpayer did not exchange the real estate for other real estate to be held for productive use in a trade or business because the property was acquired for the purpose of transferring it to the new corporation. This was a "swap and drop" transaction.

In Rev. Rul. 77-337, 1977-2 CB 305, in a prearranged plan, an individual taxpayer liquidated all the stock of a corporation and transferred the corporation's sole asset, a shopping center, to a third party in exchange for like-kind property. This Ruling concluded that the individual taxpayer did not hold the shopping center for use in a trade or business or for investment because the corporation's previous trade or business use could not be attributed to its sole shareholder for purposes of Section 1031. This was a "drop and swap" transaction.

The situation in Ltr. Rul. 200651030 was similar to Rev. Rul. 77-337, but the IRS concluded that after the trust's terminating distribution of membership interests in the LLC to multiple beneficiaries, the resulting entity was functionally like the trust and would be treated as a partnership between the beneficiaries "merely for federal income tax purposes." Nevertheless, the members of the LLC were substantially identical to the trust beneficiaries, and continued the same business (with the same managerial and operational structure) that existed before the termination of the trust. Furthermore, the termination of the trust was involuntary and by its own terms after many years in existence. These facts were sufficient for the IRS to distinguish this situation from Rev. Rul. 77-337.

The distinction drawn in this ruling between the facts at hand and Rev. Rul. 77-337 appears to be a tenuous one. Unless the LLC were viewed as a continuation of the trust by other means, the transfer of assets to the LLC immediately before the exchange would appear to be contrary to the prohibition in Rev. Rul. 77-337 against "drop and swap" transactions. The best argument would be that Rev. Rul. 77-337 involved a transfer of property from a corporation whereas Ltr. Rul. 200651030 involved a transfer to a partnership, but this distinction does not appear to comport with the Service's stated rationale in Rev. Rul. 77-337.

More important, Ltr. Rul. 200651030 completely ignored the decisions concerning "swap and drop" and "drop and swap" transactions that the Service had lost in *Magneson,* 753 F.2d 1490, 55 AFTR2d 85-911 (CA-9, 1985), *aff'g* 81 TC 767 (1983), *Bolker,* 760 F.2d 1039, 56 AFTR2d 85-5121 (CA-9, 1985), *aff'g* 81 TC 782 (1983), and *Maloney,* 93 TC 89 (1989). In these cases, the IRS litigated its position in Rev. Ruls. 75-292 and 77-337, concerning whether "drop and swap" or "swap and drop" transactions satisfied the "held for" requirement in Section 1031. The courts consistently sided with the taxpayers and disregarded these Rulings.

None of these decisions were even mentioned in Ltr. Rul. 200651030, which simply distinguished the prior Revenue Rulings. The Service's failure to acknowledge that its prior Rulings had been rejected by the courts is disconcerting, because it suggests that the IRS may continue to raise issues under the "held for" test in situations in which the courts have (at least so far) unanimously rejected the Service's position.

CONCLUSION

The three letter rulings on Section 1031 exchanges involving the use of related parties indicate the Service's willingness to approve non-abusive transactions, and to make such determinations on a fairly practical basis using a before-and-after analysis. Taxpayers should welcome these rulings and any additional pronouncements IRS makes along these lines. The "drop and swap" ruling, however, indicates that the Service may not have come around to accepting the judicial approval of such transactions, and that taxpayers who need to employ such structures should be prepared to defend them. ■

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