Examining Like-Kind Exchanges

Retiring LLC member’s interest
Support for net net gifts
The ‘State of the Art’ in Like-Kind Exchanges—2015

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Complications, variations, nuances, and idiosyncrasies abound in the rules that govern nonrecognition exchanges. Different types of property (real, personal, intangible), different types of entities having ownership, and different forms of exchanges (deferred, reverse) all may affect the bottom line, which is whether the taxpayer can defer recognizing gain.

A little more than 15 years ago, the first article on the “state of the art” in like-kind exchanges appeared in The Journal. It was followed in 2003 by an updated discussion of the techniques available to defer gain on exchanges of real property and other assets, a third installment in 2006, a fourth in 2009, and a fifth in 2012. It is time for the next installment addressing developments in this area.

BACKGROUND

The latest guidance from the IRS and the courts will be examined below. The matters discussed include:

- Ongoing issues with the characterization of property “held for investment.”
- The relevance of state law classifications of exchanged properties in the “like-kind” determination.
- A diverse array of new guidance for taxpayers with programs involving ongoing multiple exchanges of tangible personal property using a single Qualified Intermediary (QI) under Section 1031 (LKE Program).
- Identification of multiple properties as relinquished properties in a reverse exchange.
- Both leniencies in and significant expansions of the related party limitations.

Requirements for a Tax-Free Exchange

Under Section 1031(a), no gain or loss is 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 four requirements for a tax-free exchange:

1. There must be an "exchange" of relinquished property for replacement property.
2. Each "property" must not be of the type categorically disqualified from like-kind exchange treatment.
3. The replacement property must be "of like-kind" to the property relinquished.
4. Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment.

The General Rule and Boot
The general rule in Section 1031(a) requires that qualifying property must be exchanged solely for other qualifying property. Section 1031(b) provides, however, that if an exchange otherwise would be eligible for tax-free treatment under Section 1031(a) but for the receipt of cash or nonqualifying property (boot), any gain realized on the exchange is recognized to the extent of the boot received.

Liabilities
Taxable boot includes relief from liabilities, but the regulations expressly permit a taxpayer to use a "netting" concept to determine whether liabilities have been relieved. That is, the taxpayer's liabilities that are assumed or taken "subject to" by the other party to the exchange may be offset against liabilities encumbering the replacement property or taken subject to by the taxpayer. Liabilities of the taxpayer encumbering relinquished property also may be offset by cash given by the taxpayer to the other party.

Like-Kind
The replacement property must be of "like-kind" with the relinquished property. Although the law concerning this requirement is relatively established, there have been some important recent developments worth noting.

Basis
Like-kind exchanges result in tax deferral, not tax elimination. To preserve the deferred gain, Section 1031(d) provides that the basis of the replacement property received in a Section 1031 exchange equals the basis of the property transferred, reduced by any cash received and any loss recognized, and increased by any gain recognized. The basis of property received by a taxpayer in a like-kind exchange also may be increased by any cash paid by the taxpayer. The taxpayer's holding period for the replacement property will include the period during which the taxpayer held the relinquished property, i.e., the holding periods are tacked.

Multiple Properties
As a general rule, the application of Section 1031 requires a property-by-property comparison for computing the gain recognized and the basis of property received. In an exchange of multiple properties, however, the properties transferred and the properties received are separated into "exchange groups" under the special rules for the treatment of exchanges of multiple properties under Reg. 1.1031(f)–1. Each exchange group consists of the properties transferred and received in the exchange that are of a like-kind or like class.

Related Parties
Section 1031(f) provides special limitations for exchanges between certain related parties. The impetus for these related party restrictions was basis swapping by taxpayers pursuant to the basis rules of Section 1031(d) (property acquired in a like-kind exchange generally takes the basis of the property relinquished). Taxpayers were exchanging low-basis property intended to be cashed-out for high-basis property owned by an affiliate, and then having the affiliate sell the property (now with a much higher basis) in order to reduce gain or increase loss on the property to be cashed-out. Under current law, if a taxpayer exchanges property with a related person, nonrecognition treatment otherwise would apply to such exchange, and 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 generally there is recognition of the deferred gain or loss as of the date of the disposition of the property received in the initial exchange.

Multiparty and Deferred Exchanges
In a multiparty exchange, the taxpayer transfers property to a party who desires to own the taxpayer's property (a buyer) or to a party who holds property that the taxpayer wants (a seller). If the transfer is to a buyer, the buyer, in turn, acquires the replacement property desired by the taxpayer from a seller and transfers it to the taxpayer. If the transfer is to a seller, the seller conveys the replacement property to the taxpayer and sells the taxpayer's former property to the buyer. These are referred to as "buyer-cooperating" and "seller-cooperating" exchanges.

A significant advance in procedures used in multiparty exchanges arose from the Regulations allowing deferred exchanges—often referred to as Starker transactions after the Ninth Circuit decision that first sanctioned such arrangements. The Regulations set forth detailed, and generally taxpayer-friendly, guidance concerning how a taxpayer can comply with the deferred-exchange requirements in Section 1031(a)(3), which allows the transferor of relinquished property up to 45 days to identify replacement property and 180 days to close on the acquisition. The Regulations importantly contain safe harbors that taxpayers now use to avoid constructive receipt of the proceeds from relinquished property. These safe harbors
have resulted in the creation of an industry of qualified intermediaries and title companies that stand ready, willing, and able to assist taxpayers in completing deferred exchanges that are nontaxable under Section 1031.

Reverse Exchanges
In a reverse exchange, the replacement property is acquired before the sale of the taxpayer’s relinquished property to a third party buyer. The IRS has provided an important safe harbor for qualifying a reverse exchange. Subsequent guidance, however, limits the application of the safe harbor, providing that the safe harbor does not apply if the taxpayer previously owned the intended replacement property within 180 days prior to the exchange. Nevertheless, if the replacement property was previously owned by a related party, there appears to be a manner sanctioned by the IRS under which such property may be used in a reverse exchange within the safe harbor.

WHAT PROPERTY CAN BE EXCHANGED
A taxpayer’s intent to hold a property for productive use in a trade or business or for investment is a question of fact that must be determined at the time of the exchange. Taxpayers bear the burden of proving that they had the requisite investment intent. The investment intent must be the taxpayer’s primary motivation for holding the exchanged property in order for the property to qualify as held for investment purposes for Section 1031. A recent Tax Court case addresses this question in what would, except for entertaining facts, be a typical situation in which after an exchange the investment property becomes the taxpayer’s primary residence due to deteriorating finances.

In Resink, TCM 2012-18, the Tax Court addressed whether the sale of rental property followed by the purchase of a single family residence that the taxpayers subsequently moved into qualified as replacement property in a Section 1031 exchange. In 1985, brothers Patrick and Michael Reesink purchased a six-unit apartment building in San Francisco, California, from their parents. Each acquired a 50% ownership interest in the building as tenants in common. The brothers did not get along. At trial, Patrick accused Michael of attacking and strangling him on several occasions as well as poisoning him by pouring cleaning fluid into his drinking water. Conversely, Michael stated at trial that Patrick had left him “holding the bag” on several occasions while he went out to have a “real, good, fancy time.” Pursuant to the settlement agreement of their internecine litigation the brothers sold the apartment building and divided the net proceeds.

After selling the apartment building, Patrick and his wife Jill began searching for real estate around Guerneville, California, and the Lake Tahoe area. On one trip to Lake Tahoe, they met with a realtor who presented them with a few options and they eventually made an offer on one property, but the deal fell through. Thereafter, a realtor who had worked with the taxpayers on a previous purchase of investment real estate, suggested they take a look at property on Laurel Lane in Guerneville, California (the “Laurel Lane Property”) which was a 2,226-square-foot single-family home. The taxpayers used most of the proceeds from the sale of the apartment building along with a loan to purchase the Laurel Lane Property on 11/4/05. A box was checked on the loan application indicating that the Laurel Lane Property was purchased for investment.

The taxpayers posted flyers throughout Guerneville advertising the Laurel Lane Property for rent and posted “for rent” signs at the property but did not advertise in the newspaper. On two different occasions, potential renters visited the Laurel Lane Property. However, both parties ultimately notified the taxpayers by letter that they had decided not to rent the Laurel Lane Property because the monthly rent was out of their price range. The taxpayers never lowered their monthly asking price, nor did they ever find tenants for the Laurel Lane Property.

The taxpayers’ financial situation deteriorated. After failing to rent the Laurel Lane Property for several months, Patrick became concerned that they could no longer afford all of their three properties. Jill became very upset when Patrick proposed that they sell their primary residence; she loved living in San Francisco. Also, she did not want to transfer their adopted son to another school. She thought about leaving Patrick if he insisted on moving. Nevertheless, on or around 4/4/06, the taxpayers listed their primary residence for sale, entered into a contract to sell on 5/17/06, and closed on 6/30/06. The taxpayers moved into the Laurel Lane Property that same month.

The question was whether the taxpayers held the Laurel Lane Property with investment intent at the time of the exchange because of the subsequent use of the property solely as a personal residence. The IRS cited Goosby, TCM 2010–64, in which the taxpayers made the purchase of the replacement property contingent on the sale of their former personal residence and sought advice regarding whether they could move into the replacement property if renters could not be found. The taxpayer’s only rental efforts consisted of placing a single advertisement in a neighborhood newspaper. Within two weeks of purchasing the property, the taxpayers began preparations to refinish the basement. The taxpayers subsequently moved into the replacement property within two months of acquiring it. The Tax Court found that these taxpayers did not hold the replacement property with investment intent at the time of the exchange.

The Tax Court differentiated the facts in Resink from those in Goosby

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because the Reesinks placed fliers throughout Guerneville, showed the Laurel Lane Property to potential renters, waited almost eight months before moving in, and refrained from using the property for recreational purposes before moving in. More importantly, the taxpayers decided to sell their personal residence almost six months after purchasing the Laurel Lane Property. The Tax Court found the trial testimony of one of the potential tenants to be credible, as well as Jill’s testimony that she never discussed moving to Guerneville until after the exchange had been completed and when they believed they were in a financial predicament. The Tax Court found that the taxpayers held the property with investment intent at the time of the exchange and therefore were not required to recognize gain on the sale of the apartment building.

The Tax Court also distinguished Goolsby in another recent case. In Adams, TCM 2015-7 the taxpayer owned a rental-home in San Francisco, California. When the tenant left, Adams exchanged the home for a home in Eureka, California, which he rented to his son, Bill, at below-market rent. At trial, Adams explained that he chose the home in Eureka because it was where Bill resided and suited the size of Bill’s family. Notwithstanding, Adams contended that the rental was a business rental and not a personal rental, because Bill had extensive experience remodeling homes, the Eureka home was dilapidated, and he charged below market rent because Bill had agreed to, and in-fact did, remodel and improve the home. On these facts, the Tax Court concluded that the Eureka home was held for investment purposes and that its exchange for the San Francisco home qualified as a Section 1031 exchange. The Tax Court’s ruling in Adams applies to support the principle that a meaningful personal purpose in holding a property does not preclude the existence of a primary intent to hold the property for investment.

Dual-Use Property

The treatment of property held by a taxpayer for both sale and rental purposes is an ongoing issue. The IRS issued Notice 2015-13, 2015-12 IRB 659, in which it requested comments for the future issuance of guidance intended to clarify the circumstances under which construction and agricultural equipment that is dual-use property is properly treated as dealer property or as business property. Dealers in such equipment always would like to sell the equipment; however, their business models often require them to engage substantially in leasing activities with respect to their inventory. The IRS has used the following factors to determine whether dual-use property was dealer property: (1) the proportion of dual-use property sold versus leased, (2) whether or not leased property was commonly leased for a period extending until after the property’s useful life, (3) the proportion of revenue from sales versus leases, (4) the frequency of a sale option in lease contracts and the frequency of exercise, (5) the manner most commonly used to dispose of dual-use property, and (6) a dealer’s initial classification of the property for U.S. federal tax purposes. The IRS requested comments with regard to whether: (1) the above facts should be evaluated separately for different industries, (2) a safe harbor or bright-line test would be better than reliance on a factor test, (3) guidance on this issue is necessary only for dealers of construction and farming equipment or whether other industries require similar guidance, and (4) the industry properties are of like kind for purposes of Section 1031, and all of the facts and circumstances should be considered in determining whether properties are of the same nature and character; and thus, are of like kind.

WHAT IS LIKE KIND

Properties are generally “of like kind” if they are of the same nature and character. State law property classifications, while relevant for determining if property is real or personal property, are not determinative of whether properties are of the same nature and character. Rather, federal income tax law controls whether exchanged

In CCA 201238027, the IRS Chief Counsel’s office attempted to clarify and illustrate that conflicting state law classifications of exchange properties are not determinative for Section 1031 purposes.
state laws and state policies. For example, the CCA concluded that a natural gas pipeline in State A constructed along a right of way on real property that is classified as personal property in State A can be exchanged under Section 1031 for a State B natural gas pipeline that is constructed along a right of way on real property and that is classified as real property in State B. Notwithstanding the conflicting state law classifications, the natural gas pipelines are inherently permanent structures affixed to real property that will ordinarily remain for an indefinite period of time and are transferred as part of the land to which they are affixed. Their same basic nature and character rightly means they are like kind real property for Section 1031 purposes.

The CCA also concludes that a steam turbine attached as a fixture in a State A land improvement (a building) as a component of a system for the commercial production of electricity that is treated as real property in State A (a "State A Turbine") can be exchanged under Section 1031 for a steam turbine attached as a fixture in a State B land improvement as a component of a system for the commercial production of electricity that is treated as personal property in State B. Again, notwithstanding the conflicting state law classifications, as machinery used in the commercial production of electricity, both turbines are of the same nature and character, and therefore, are like-kind personal property for Section 1031 purposes.

The CCA then concludes that a State A Turbine is not of like kind with and cannot be exchanged under Section 1031 for raw land in State B, even though the State A Turbine is treated as real property in State A. While at first blush this may seem like a further logical step, the notion that state law real estate is not considered real estate for purposes of Section 1031 is not necessarily supported by existing authorities. Such a notion arguably raises not-easily-answered questions about how to determine what is like kind. The practical takeaway should be that if exchanged properties are not clearly both real estate or personal property, and not clearly of the same nature and character, further analysis should be undertaken.

Leasehold Interests

Certain long-term leasehold interests in real property can be of like kind to a fee interest in real property. Reg. 1.1031(a)(11)(c) provides a safe harbor for a leasehold of 50 years or more. Recent cases have tended to show that the 50-year threshold is less of a safe harbor and more of a bright line test for determining when leasehold interests are like kind to fee interests in real estate. In VIP Industries, Inc., TCM 2013-157, a taxpayer claimed that a 21-year leasehold interest in a motel property was like kind to a transferred fee interest, and that even if the leasehold was not like kind, the interest received in the improvements to the motel property should be like kind. The Tax Court held that a leasehold interest for a 21-year term was insufficient to be like kind to a fee interest, and that since the improvements would go to the lessor at the expiration of the lease, they too were not like kind to a fee interest.

Deferred Exchanges

Deferred exchanges are often referred to as "Starker transactions after the Ninth Circuit decision that first sanctioned such arrangements. In Starker, 602 F.2d 1341, 44 AFTR2d 79-5525 (CA-9, 1979), the taxpayer transferred property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date. Congress responded by enacting Section 1031(a)(5), which allows the transferor of relinquished property up to 45 days to identify replacement property and 180 days to close on the acquisition of the replacement property.

The Identification Rules

The taxpayer may identify as replacement property any three properties or, if more than three, any number of multiple properties with a fair market value (FMV) not in excess of 200% of the FMV of the relinquished property. Most taxpayers prefer to use the three-property rule because of the certainty it engenders due to the lack of need to establish fair market values of any property involved.

The Safe Harbors

The key issue in deferred exchanges is, for the purposes of Section 1031, that the taxpayer never actually or constructively receive the non-like kind proceeds of the relinquished property that are used to acquire the replacement property. Reg. 1.1031(k)-1(g) provides safe harbors for taxpayers to avoid actual or constructive receipt for purposes of Section 1031. The safe harbors provide rules for security and guarantee agreements used to insure the transfer of the replacement property; escrow accounts and trusts that can be used to hold the cash proceeds of a deferred exchange before they are used to acquire replacement property; and, perhaps most importantly, the rules for the use of a QI to facilitate a deferred exchange.

Qualified Intermediaries

In an exchange using a QI, the taxpayer transfers the relinquished property to the QI. Generally, the QI will sell the relinquished property and use the proceeds to purchase replacement property that is then conveyed to the taxpayer. In such a transaction, the subsequent receipt of like-kind replacement property by the taxpayer is treated as an exchange, and the QI's receipt of the cash proceeds from the sale of the relinquished property will not be treated as actually or constructively received by the taxpayer. The utility of QI facilitated like-kind transactions has led businesses to set up entire LKE Programs. However, in executing LKE Programs, taxpayers need to be careful to ensure that the program satisfies the detailed regulatory requirements for QIs, as well as further requirements discussed below.

NOTES

2 See Walker; IRS Mocks Like-Kind Waters in Guidance Considering State Law Classification, 18 ITAX 13 January 2010.
**Disqualified Person**

A QI must satisfy a number of requirements, including the requirement that the QI not be a “disqualified person,” which term includes an agent of the taxpayer at the time of the transaction, such as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent within the two-year period ending on the date of the transfer of the first of the relinquished properties. Persons who bear a relationship described in Section 267(b), e.g., family members including ancestors and lineal descendants, are also disqualified persons. In a recent case, the Tax Court illustrated the importance of following the letter of the law with respect to “disqualified person” treatment.

In *Blangiaro*, TCM 2014–110, the Tax Court addressed whether the taxpayer had taxable capital gain from the sale of residential property (the Property) on 6/15/06. On 8/29/06, the taxpayer purchased a parcel of vacant land (the Land). The taxpayer maintained that the Property was held for business use and claimed he carried out a Section 1031 deferred exchange, with his son, an attorney, acting as an intermediary with regard to the transaction. The IRS argued that the sale of the Property and the acquisition of the Land did not constitute a valid Section 1031 deferred exchange because the taxpayer failed to use a QI who was not a disqualified person.

The taxpayer acknowledged that there was no direct exchange and that the intermediary used in the transaction was his son. However, the taxpayer asserted that he met the requirements of the regulatory safe harbor because (1) his son was an attorney; (2) the funds from the Property were held in an attorney trust account; and (3) the real estate documents referred to the transaction as a Section 1031 exchange. The Tax Court did not accept this argument because the regulations are explicit that a lineal descendant is a disqualified person and makes no exception based on profession. Consequently, the Tax Court found that the taxpayer’s disposition of the Property and subsequent acquisition of the Land was not a deferred exchange within the purview of Section 1031.

*Blangiaro* appears to have been a relatively easy and straightforward case insofar as application of the QI safe harbor found in the regulations. The taxpayer tried to use his son, an obviously disqualified person, as a QI. What the case does not consider, perhaps because the taxpayer represented himself pro se in the matter, was whether loss of the safe harbor should automatically result in a taxpayer’s constructive receipt of proceeds received by an intermediary or whether more thorough analysis of this issue is required when the safe harbor is unavailable. This issue remains to be considered by the courts.

Further, a more subtle issue that can arise with respect to QIs is whether or not a party is a disqualified person for being an “agent” of the taxpayer in a capacity other than as a QI. A recent letter ruling provides a good example of this issue.

**Lt. Rul. 201308020.** A partnership was in the business of providing QI services and made available to its clients software developed in-house that tracked and managed a high volume of exchanges in LKE Programs. The software enabled clients to track and manage exchanges as well as ensuring that the partnership fulfilled its obligations as a QI. Specifically, the software assisted the client in (1) matching relinquished and replacement properties, (2) preparing and submitting 45-day identifications, and (3) computing depreciation and gain or loss on the LKE Program assets. The partnership used this software to comply with the restrictions on the use of the exchange funds and to ensure proper identification of replacement property. The software was not otherwise commercially available. The IRS held that the partnership’s provision of this software to its LKE Program clients did not make the partnership an agent of its clients because the software merely enabled an LKE Program client to manage a high volume of exchange transactions and assisted the partnership in fulfilling its obligations as QI. Although the software also computed depreciation and gain or loss from an LKE Program client’s transactions, those functions did not result in the partnership being considered an accountant for its clients. The IRS reasoned that this was because the depreciation and gain or loss functions were essentially automated math calculations based on data input by the LKE Program client, and therefore, did not rise to the level of an accountant/client or other agency relationship. Accordingly, the partnership was not found to be a disqualified person to an LKE Program client as a result of providing such software.

**Constructive Receipt**

Constructive receipt is a concept generally used in tax accounting, but that has special importance and application with respect to deferred like-kind exchanges, because if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

The concept of constructive receipt is used to determine timing for the inclusion of income. Income, although not actually reduced to a taxpayer’s possession, is constructively received in the tax year during which it is credited to the taxpayer’s account, set aside for the taxpayer, or otherwise made available so that the taxpayer may draw on it at any time, or so that taxpayer could have drawn on it during the tax year if notice of intention to withdraw has been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to “substantial limitations or restrictions.” With respect to deferred like-kind exchanges, despite the restrictions that must be im-

**Notes**

3 Reg. 100308000.
4 Reg. 100308000.
5 Reg. 1461200.
posed on proceeds from the sale of relinquished property received by a QI, an exchanging taxpayer may still enjoy some benefit from the use of such funds without being treated as constructively receiving the funds, as shown in a recent CCA.

CCA 201225201. The taxpayer was in the business of renting equipment to customers for use in farming, construction, manufacturing, and warehousing. The taxpayer maintained two lines of credit with two creditors, and all of the taxpayer’s business assets were pledged as security to those creditors. Proceeds from the lines of credit were used generally for the taxpayer’s business and its LKE Program. The agreement between the taxpayer and the QI for its LKE Program provided that the taxpayer did not have the right to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the QI. The QI would sell the taxpayer’s relinquished property and use the proceeds to pay down the taxpayer’s debt on the line of credit to which it was pledged. The proceeds of the sale of relinquished property were deposited directly into a joint QI/Taxpayer account and then immediately disbursed by the QI to satisfy the taxpayer’s obligation on the line of credit. The taxpayer would then acquire replacement property by borrowing new funds. In the CCA, the field attorney argued that under the taxpayer’s arrangement, the taxpayer constructively received the cash proceeds from the sale of the relinquished property because the cash proceeds were used to satisfy the taxpayer’s credit obligations. However, the CCA concluded differently because it viewed the instant circumstance as comparable, materially, to Example 5 of Reg. 1.1051(k)-1(c)(5), which states:

B, the transferor of relinquished property in a deferred exchange, transfers property that is encumbered with a $50,000 mortgage to C on May 17, 1991. C assumes the mortgage on that date. On July 15, 1991, B receives the replacement property and assumes a $20,000 mortgage encumbering the replacement property. The consideration received by B in the form of the liability assumed by C ($50,000) is offset by the consideration given by B in the form of the liability assumed by B ($20,000). The excess of the liability assumed by C over the liability assumed by B ($10,000), is treated as “money or other property.” Thus, as provided in § 1051(b)(6), B recognizes gain in the amount of $10,000.

The example relies on Reg. 1.1051(b)-1(c), which treats liabilities assumed by the counter-party in connection with its acquisition of relinquished property as boot to the taxpayer, but allows the taxpayer to offset any such boot received with liabilities that the taxpayer assumes in connection with its acquisition of replacement property. The CCA recognized two distinctions between this example and the instant facts, (1) the lines of credit were also used for general business operations and (2) there was a payment of debt and not an assumption of debt, but determined that the distinctions were not material. The CCA therefore concluded that the taxpayer’s LKE Program resulted in Section 1051 transactions under which the taxpayer was not required to recognize gain to the extent that the debt repaid from the proceeds of the sale of relinquished property was equal to the debt incurred to purchase replacement property.

Special Rules Applicable to LKE Programs
Rev. Proc. 2005-39, 2005-1 CB 971, provided guidance on the qualification of LKE Programs. A taxpayer is required to, among other things: (1) use a single, unrelated QI to accomplish the exchanges; (2) enter into a written master exchange agreement (MEA) with the QI; (3) assign to the QI, in the MEA, the taxpayer’s rights (but not necessarily its obligations) in some or all of its existing and future agreements to sell relinquished properties and/or to purchase replacement properties; and (4) provide written notice of the assignment to the other party to each such existing and future agreements. A recent letter ruling explored the level of detail that needed to go into the written notice for requirement (4).

Lit. Rul. 201252018. Taxpayer was a corporation primarily engaged in the business of leasing vehicles and issuing loans for the purchase of vehicles. In its leasing business, taxpayer exchanges tangible personal property under Section 1051 by transferring vehicles coming off-lease to unrelated parties and acquiring vehicles subject to leases from unrelated Z-Dealers. Taxpayer uses one QI to effectuate these exchanges under Section 1051 and entered into an MEA as provided in Rev. Proc. 2005-39. The MEA included a blanket assignment clause by which taxpayer assigns its rights (but not its obligations) in its existing and future vehicle sales and purchase agreements to QI. At the end of each lease term (or during the lease term if the lease ends earlier), taxpayer will transfer the vehicle (an off-lease vehicle), through QI, to (1) customers/lessees, (2) unrelated Z-Dealers; and (3) Non-Z-Dealers. The sales to dealers can occur by way of the internet and through auction sales and direct sales. When a vehicle is sold or purchased in an exchange under its exchange program, taxpayer provides blanket notice (Notice) of its assignment of its rights in its existing and future vehicle sales and purchase agreements as follows:

- When taxpayer transfers off-lease vehicles to existing customers/lessees, it includes the Notice on the credit applications and on the lease agreements with its lease customers. Also, because some leases were already in effect prior to the start of the exchange program, taxpayer provided a one-time Notice to all existing customers/lessees through monthly invoice statements.

- When taxpayer transfers off-lease vehicles to unrelated Z-Dealers, it provides the Notice separately in its sales invoice, certificate of title, and purchase confirmation provided to the unrelated Z-Dealer purchasing the off-lease vehicle. This is in addition to the Notice included in its lease agreement. Also, taxpayer provides one-time Notice to each unrelated Z-Dealer:

  - When taxpayer transfers off-lease vehicles to Z-Dealers through an
internet vehicle purchase system (System), it provides the Notice on the log on the System’s website screen. It also provides the Notice as one of the terms of purchase on the terms of purchase website screen. The Notice also appears on the bill of sale sent to the unrelated Z-Dealer. 

- When taxpayer transfers off-lease vehicles to Z-Dealers through the System when the respective vehicle has been consigned to auction but the auction date has yet to occur, it provides the Notice on the log on the System’s website screen. The Notice is also included as one of the terms of purchase on the terms of purchase screen on the System’s website. Taxpayer also sends a fax to the auction, listing each consigned vehicle and including the Notice to the auction.

- When taxpayer transfers off-lease vehicles at auction, it sends a fax to the auction that lists each vehicle (the Annual Notice). Also, taxpayer will provide the Notice to each Non-Z-Dealer that was not included in the Annual Notice or Initial Notice on learning of its purchase of a vehicle from taxpayer. On the transfer of each vehicle to a Non-Z-Dealer, taxpayer will, follow this Notice to the Non-Z-Dealer with a specific Notice each time the Non-Z-Dealer purchases a vehicle from taxpayer. Taxpayer will also include the Notice in the bill of sale documents sent to the purchaser.

- When taxpayer acquires vehicles subject to leases from Z-Dealers, taxpayer (1) provides a stand-alone announcement that contains the Notice to each participating Z-Dealer; (2) provides the Notice in the Z-Dealer agreements with the respective Z-Dealers; (3) includes the Notice in the credit application used in each purchase transaction, including credit applications available through taxpayer’s website; (4) includes the Notice on its website; (5) includes the Notice in its lease agreement; and (5) provides the Notice in its acceptance confirmation sent to a selling unrelated Z-Dealer.

In Ltr. Rul. 201242003, the IRS approved a transaction in which a taxpayer and a related party both entered into separate QEAAs for parking the same property held by a single EAT (the Property).

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**Other Issues for LKE Programs**

Because LKE Programs often have a high volume of transactions, certain properties initially matched as replacement properties may subsequently be determined to be ineligible as replacement properties. In such cases, the taxpayer will want to rematch its relinquished property to other timely identified and acquired eligible replacement properties not previously reported as matched, thereby retaining like-kind exchange treatment for the rematched transaction. This issue is explored in a recent TAM.

**TAM 2014-27012.** Taxpayer distributed, sold, serviced, rented, and financed equipment. Within its separate rental division, taxpayer established a LKE Program through which it disposed of and exchanged pieces of equipment designated as relinquished properties. Taxpayer used an automated algorithm to match replacement properties to relinquished properties that applied a “first-in-first-out” (FIFO) methodology. The excess re-

placement properties that were not needed as replacement properties in the LKE Program were capitalized at full cost and amortized as rental equipment, as provided under section 5.02(10) of Rev. Proc. 2005-39. The IRS Examination Team determined that some of the replacement properties were not eligible for exchange under Section 1031 because they were held primarily for sale rather than for productive use in a trade or business or for investment. In response, the taxpayer asserted that other previously unmatched replacement properties (also acquired within the relevant 45-day identification period) could be matched with the eligible relinquished properties. The Examination Team argued that the taxpayer’s matching of ineligible replacement properties was binding upon the filing of taxpayer’s
return and that a later rematch was not permitted.

The TAM concluded that these other eligible replacement properties, which were timely identified and acquired, but not reported as matched, would qualify as replacement properties. The TAM reasoned that this conclusion logically follows from the well-established principle that Section 1051 is a mandatory, non-elective provision that applies even if a taxpayer is unaware that a like-kind exchange has occurred or tries to avoid its treatment by papering its exchanges as sale and purchase transactions. Consistent therewith, how a taxpayer reports a transaction on its income tax return does not determine whether Section 1051 applies to the transaction. Because the unmatched replacement properties were properly identified as a result of being received by the taxpayer under the LKE Program before the end of the identification period, the eligible unmatched replacement properties would qualify and rematching was therefore appropriate.

The TAM dismissed a number of arguments made by the Examination Team, many of which involved an incorrect application of Section 1051 law. The Examination Team also raised the concern that to allow rematching after the due date of the return would place an unworkable administrative burden on the IRS in examining exchanges in an LKE Program, and that if a taxpayer could rematch each time there is a proposed adjustment, the taxpayer's purported exchanges would remain a moving target until the expiration of the statute of limitations. The TAM addressed this concern by noting that the facts did not show that the taxpayer was conducting a mass LKE Program in bad faith or attempting to outlast the statute. The TAM accepted that there was additional burden on Exam, but that this is an unavoidable burden inherent in a provision of the Code that does not irrevocably bind the taxpayer and the IRS to the position originally reported by the taxpayer on its return.

REVERSE EXCHANGES
In a reverse exchange, the replacement property is acquired before the sale of the taxpayer's relinquished property. Because the IRS stated that the regulations for deferred exchanges under Section 1031 did not apply to reverse-Starker exchanges, prior to 2000, taxpayers attempted to use a wide variety of accommodation ownership arrangements and related mechanisms to facilitate reverse exchanges.

In the interest of sound tax administration, the IRS provided in Rev. Proc. 2000-57, 2000-2 CB 308, a workable means of qualifying an accommodation ownership arrangement if there was a genuine intent to accomplish a like-kind exchange at the time the taxpayer arranged for the accommodation party's acquisition of the replacement property, so long as the taxpayer actually accomplished the exchange within a short time thereafter. A safe harbor allows a taxpayer to treat an exchange accommodation titleholder (EAT) as the owner of property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying reverse exchange. Moreover, the procedure gives important flexibility to taxpayers and EATs in setting up a qualified exchange accommodation arrangement (QEA). Recent rulings provide a broad array of options for taxpayers interested in deferring gain using reverse exchanges.

Separate QEAs for Parking the Same Property Held by an EAT
In Ltr. Rul. 201242005, the IRS approved a transaction in which a taxpayer and a related party both entered into separate QEAs for parking the same property held by a single EAT (the Property). In the facts of this ruling, a REIT was the sole general partner and 95.6% owner of a limited partnership (Taxpayer), which owned 99% of another limited partnership (Affiliate). The other 1% of Affiliate was owned by a qualified REIT subsidiary (QRS), which was wholly owned by REIT, and that as a QRS was treated as a disregarded entity. Taxpayer and Affiliate each owned one or more properties that were of like kind to Property, and each of these entities targeted Property for acquisition as replacement property through separately structured like-kind exchanges. The seller of Property required that the sale of Property close on a certain date; therefore, each initiated a reverse exchange under the safe harbor provisions of Rev. Proc. 2000-57 and complied with the requirements therein—entering into a QEA with EAT—with a bona fide intent to acquire the Property as replacement property.

Taxpayer's QEA provided that it acknowledged that EAT had entered into a concurrent QEA for Property with Affiliate, which gave Affiliate rights to acquire Property, in whole or part, to complete like-kind exchanges. Under Taxpayer's QEA, Taxpayer's right to acquire Property was subject to it giving notice to EAT of its intention to acquire Property, in whole or part. This was subject, however, to a proviso that Taxpayer's rights terminate prior to prior delivery of such notice by Affiliate. The agreement also provided that if Affiliate gave prior notice of its intent to acquire Property, EAT had no further obligation to transfer Property to Taxpayer, but that if Affiliate stated its intention to acquire only a portion of Property, EAT's obligations to transfer the balance of Property to Taxpayer were unaffected. Affiliate simultaneously entered into its own QEA with EAT for Property under substantially the same terms and conditions. EAT acquired title to Property using funds that Taxpayer advanced. Within the 45-day identification period Taxpayer and Affiliate each identified property that each proposed to transfer as relinquished property according to terms of its respective QEA with EAT.

The IRS concluded that Taxpayer's QEA to acquire Property constituted a separate and distinct QEA even though Affiliate simultaneously entered into a separate QEA with the same EAT to acquire the same property, provided that Taxpayer and Affiliate each had a bona fide intent to
acquire Property pursuant to each of its QEAAs. The IRS found no issue because Rev. Proc. 2000-37 does not prohibit an accommodation party from serving as an EAT to multiple taxpayers under multiple and simultaneous QEAAs for the same parked property. The fact that Affiliate’s QEEA failed because Taxpayer timely acquired Property under its QEEA using the same EAT did not invalidate Taxpayer’s QEEA.

Ltr. Rul. 201416006 involved the same question as Ltr. Rul. 201242005, and the IRS similarly ruled that Section 1031 applies to a transaction in which Taxpayer and two related parties enter into separate QEAAs for parking the same property held by an EAT. The IRS ruled that, based strictly on the information submitted and each representation made, including the representation that Taxpayer and Affiliates each have a bona fide intent to acquire Property pursuant to each of its QEAAs, Taxpayer’s arrangement to acquire Property in whole or in part constitutes a QEEA separate and distinct from the QEEAs entered into by Affiliates, with separate application of the identification rules.

The use of multiple separate QEAAs for parking the same property held by an EAT, practically enables a workaround when the taxpayer and affiliates own various properties being offered for sale but are not sure which relinquished property they will sell, or could be sold in time.

Services Performed by the EAT
Section 3.05 of Rev. Proc. 2000-37 states that services for the taxpayer in connection with a person’s role as the EAT in a QEEA shall not be taken into account in determining whether that person or a related person is a disqualified person. Section 4.05 of the Revenue Procedure lists permissible arrangements that will not cause property to fail to be treated as being held in a QEEA, regardless of whether such arrangements contain terms that typically would result from arm’s-length bargaining between unrelated parties:

1. An EAT that satisfies the requirements of the QI safe harbor may enter into an exchange agreement with the taxpayer to serve as the QI in a simultaneous or deferred exchange of the property.
2. The taxpayer or a disqualified person guarantees some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnifies the EAT against costs and expenses.
3. The taxpayer or a disqualified person loans or advances funds to the EAT or guarantees a loan or advance to the EAT.
4. The property is leased by the EAT to the taxpayer or a disqualified person.
5. The taxpayer or a disqualified person manages the property, supervises improvements of the property, acts as a contractor, or otherwise provides services to the EAT with respect to the property.
6. The taxpayer and the EAT enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the EAT.
7. The taxpayer and the EAT enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the EAT’s receipt of the property be taken into account upon the EAT’s disposition of the relinquished property through the taxpayer’s advance of funds to, or receipt of funds from, the EAT.

A recent letter ruling confirms that this list is non-exhaustive and that an EAT is more generally permitted to perform services that are reasonably related to facilitating the exchange.

Ltr. Rul. 201332010. The taxpayer was in the vehicle leasing business and used an EAT for its acquisitions of new vehicles and dispositions of old vehicles. The taxpayer would order a vehicle from the EAT and assign the acquisition right to a QI. Subsequently, the EAT would issue a purchase order from the manufacturer. The manufacturer would then issue an invoice and manufacturer’s statement of origin, which were indicia of ownership used later to acquire title to the vehicle. EAT and the taxpayer were beneficiaries of separate sub-trusts of a Delaware business trust, where the trustee was a third-party bank. For U.S. federal tax purposes, the trusts were disregarded and the EAT and the taxpayer were treated as owning separate disregarded entities, such that each was treated as directly owning the assets of its respective sub-trust. The EAT would sell the vehicle to the trust, a transaction treated as a sale under state law. Vehicles transferred to the trust were allocated to the EAT’s sub-trust. The vehicles were so held until improvements and modifications to the vehicles were complete, at which time the vehicles were transferred to the taxpayer’s sub-trust.

The old vehicles in the taxpayer’s sub-trust were sold to the EAT, which in turn sold the vehicles to the taxpayer’s disregarded sales entity. For U.S. federal tax purposes, the transaction was disregarded because the EAT was treated as an agent. Aside from acting as an EAT, the EAT acted as the taxpayer’s procurement entity for state sales tax purposes which required the EAT to (1) acquire a dealer license for state sales tax purposes and a wholesale dealer license of motor vehicles; (2) act as the procurement entity and reseller for state sales purposes; (3) acquire legal title to the vehicles; (4) register to do business as a foreign corporation in any and all states where the taxpayer had transactions; and (5) obtain and maintain a valid sales tax permit in virtually every state that levies a sales tax.

The IRS held that the EAT was not a disqualified person because intermediaries may perform a variety of tasks and functions reasonably connected with facilitating exchange transactions without disqualifying their status as QIs or EATs. Even though the EAT’s services as a procurement agent with respect to state sales tax on trade-ins are not ex-
pressly described in Rev. Proc. 2000-57 as permissible services that may be performed by an EAT, such services are akin to the services described in Rev. Proc. 2000-57 because they are services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Section 1031.

Rev. Proc. 2004-51
The IRS modified Rev. Proc. 2000-57 in Rev. Proc. 2004-51, 2004-2 C.B. 294, to provide that the reverse exchange safe harbor does not apply if the taxpayer owns the property intended to qualify as replacement property within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an EAT pursuant to a QEA.

By its terms, however, Rev. Proc. 2004-51 applies only when the replacement property is owned by the taxpayer and does not refer to replacement property owned by a related party. Rev. Proc. 2004-51 further stated that the IRS and Treasury Department intended to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party, the accommodation party makes improvements to the land, and it then transfers the leasehold with the improvements to the taxpayer in exchange for other real estate. This left the status of such transactions unclear. However, according to a recent letter ruling, it appears that the IRS believes the transactions are within the safe harbor of Rev. Proc. 2000-57.

Lit. Rul. 201408019. Taxpayer was an LLC treated as a partnership for tax purposes, which was owned by a limited partnership (LP) and by a taxable REIT subsidiary, which was wholly-owned by LP. Accordingly, Taxpayer and LP were related parties under Section 1031(f)(5). The LP was an affiliate of a publicly-held REIT, and also owned a vacant, outdated building and land. The land was owned by one disregarded entity and was leased for more than 50 years to another disregarded entity, which owned the building. The building was demolished, leaving vacant land.

The ruling addresses the following series of transactions: Taxpayer relinquished property to a QI for sale to a third-party. LP leased the vacant land to an EAT for more than thirty years, and Taxpayer advanced funds to the EAT to finance construction of a new building on the vacant land. The construction was to be overseen by Taxpayer, but the EAT would hold the qualified indicia of ownership. Taxpayer would identify the sublease and the improvements as replacement property. Within 180 days after entering the sublease, the EAT would convey the sublease and the improvements to Taxpayer through the QI. The IRS ruled that the transaction qualified for non-recognition under Section 1031 because the sublease was transferred to the EAT from a party related to the Taxpayer, not from the Taxpayer directly. The IRS stated that Rev. Proc. 2004-51 had no bearing here because the replacement property had not been owned by Taxpayer.

RELATED-PARTY EXCHANGES
Section 1031(f) provides special limitations for exchanges between certain related parties. The impetus for these related party restrictions was basis swapping by taxpayers pursuant to the basis rules of Section 1031(f) (property acquired in a like-kind exchange generally takes the basis of the property relinquished). Taxpayers were exchanging low-basis property intended to be cashed-out for high-basis property owned by an affiliate, and then having the affiliate sell the property (now with a much higher basis) in order to reduce gain or increase loss on the property to be cashed-out.

Section 1031(f)(1) provides that 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. 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.

Under Section 1031(f)(2), certain dispositions are excepted from this recognition rule. 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 IRS's satisfaction that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax. Lastly, Section 1031(f)(4) provides an anti-abuse rule stating that nonrecognition under Section 1031 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).

Teruya Brothers, Ocmulgee Fields, and North Central Rental & Leasing
One way to circumvent Section 1031(f)(1) is through the use of a QI or an EAT as the party through whom the taxpayer conducts an exchange because they are by definition not persons related to the taxpayer. Instead of a taxpayer directly swapping a low-basis property with a related party, a taxpayer could transfer the low-basis property to the buyer through a QI, which uses the proceeds of the relinquished property to purchase the high-basis property from the related party as replacement property. The end-result is exactly the same as a direct swap with the related party. Such an insertion of a QI was found to be a violation of the Section 1031(f)(4) anti-abuse rule in both Teruya Brothers, Ltd., 580 E3d 1058, 104 ATFRd2d 2009-6274 (CA-9, 2009) and Ocmulgee Fields, Inc., 613 E3d 1560, 106 ATFRd2d 2010-5820 (CA-11, 2010). A recent case explores this issue further and expands the scope of the prior rulings.
In North Central Rental & Leasing LLC, 779 F.Supp. 758, 115 AFTR2d 2015-995 (CA-8, 2015), the Eighth Circuit analyzed a transaction involving five parties: (1) Butler, an industrial equipment dealer; (2) North Central, Butler's subsidiary that ran Butler's leasing business; (5) Accrual, the QI; (4) Caterpillar, Butler's third-party equipment supplier, and (5) Buyer, a third-party purchaser of used equipment. North Central would transfer its old equipment to the QI, which sold it to Buyer. Butler purchased new equipment from Caterpillar, which would not require payment until six months after receipt. The QI purchased the new equipment from Butler and transferred it to North Central as its replacement property. The issue was that, in effect, Butler received an up-to-six-month, interest-free loan from each exchange because it could use the cash it received from the QI (which was the proceeds from North Central's relinquished property) for such period of time before it was obligated to pay Caterpillar for the new equipment.

The president and CEO of the QI testified at trial that it would have paid the sales proceeds from the relinquished property directly to Caterpillar if the new equipment were not purchased via the QI, which meant that if Butler had not been involved, neither Butler nor North Central would have received the de facto interest-free loan. In the court's view, Butler was not necessary to the transactions at issue, but obtained the use of significant amounts of cash. Because unnecessary parties were involved and a related party ended up receiving cash, the court held that the transactions were structured to avoid the purposes of Section 1051(f), and therefore, Section 1051(f)(4) applied to disqualify North Central's exchanges from nonrecognition treatment. Section 1051(f)(4) was intended to prevent the circumvention of Section 1051(f)(1) by the insertion of an unrelated third party into the exchange.

In the author's view, the Eighth Circuit's decision went beyond the limited precedent set forth in Tenaya Brothers and Oenology Fields, which had held against basis swapping with a related party via the use of a QI. In North Central, there was no basis swapping with a related party because new equipment from Caterpillar was the replacement property. In Tenaya Brothers and Oenology Fields, the taxpayers and affiliates began with two properties and finished with one property and so the cash proceeds from the sale resulted in a change in the form of the taxpayer's investment. In contrast in North Central, the taxpayer and affiliates began with one property and finished with one property, which meant that the series of transactions did not result in any overall change in the taxpayer's investment and the taxpayer did not cash in on any property. The court appeared to not like the fact that the transaction was complex, and that Butler obtained the benefits of the use of the cash proceeds, even though it was for a limited period. Although neither of these facts is contrary to the purpose of Section 1051(f) found in the legislative history (basis swapping), the court invoked the anti-abuse rule in Section 1051(f)(4).

The Eighth Circuit thus expanded the domain of the anti-abuse rule in Section 1051(f)(4), beyond what was intended by Congress, to cover any transaction in which a related party enjoys a benefit prohibited to the taxpayer engaging in a Section 1051 exchange. One of the many lessons to be learned from this case is for taxpayers to be very careful when bringing a related party into a like-kind exchange transaction. Although this case highlights the risk associated with the acquisition of replacement property from a related party, the following letter rulings involve a series of related-party like-kind exchanges that qualified under Section 1051.

A Series of Qualifying Exchanges Between Related Parties

In Ltr. Rul. 201216007, the IRS ruled that Section 1051(f) does not preclude the benefits of Section 1051 in the case of a series of transactions between related parties if each transaction in the series otherwise qualifies as a like-kind exchange under Section 1051(a), and none of the related parties receive more than a minimal amount of nonlike-kind property in their transactions. In the facts of the ruling, Parent-REIT is the sole general partner and owns 92.9% of Operating Partnership (OP), which owns 99.9% of Taxpayer-REIT.

Taxpayer-REIT engaged in both a parking arrangement and a deferred exchange involving an EAT, a QI, and a qualified trust with respect to its relinquished property. Pursuant to a QEAA, the EAT acquired replacement property number one from an unrelated seller (RP#1). Taxpayer-REIT timely identified relinquished property in connection with the QEAA for RP#1 and conveyed the relinquished property to an unrelated buyer through the QI, which tendered the cash to the EAT, which conveyed RP#1 to Taxpayer-REIT. Taxpayer-REIT timely identified additional replacement property which was owned by a wholly-owned disregarded subsidiary of OP (RP#2). In the exchange through QI, the OP entered into its own deferred exchange agreement with a QI to engage in a fully compliant like-kind exchange. OP timely identified three potential replacement properties, which included properties held by unrelated third-parties and by affiliates. To the extent any OP replacement property was owned by an affiliate prior to transfer of such property to OP, the affiliate would enter into a deferred exchange agreement with a QI providing for the affiliate's fully compliant exchange of those properties for third party properties.

The IRS ruled that Sections 1051(f)(1) and (f)(4) did not apply to disqualify Taxpayer-REIT from the benefits of Section 1051 in its exchange with related parties provided that (1) each related party transferring replacement property into the series of exchanges also engages in its own like-kind exchange and receives non-

See also Lipton, "Eighth Circuit Sheds Light on Like-Kind Exchanges," 122 JTR 262 (June 2010).

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like-kind property equal to no more than 5% of gain realized, and (2) Taxpayer-REIT and the related parties hold their replacement properties for at least two years after the date of the last transfer of property in the series of exchanges.

The facts In Ltr. Rul. 201220012 were similar to Ltr. Rul. 201216007, and the IRS again ruled that Section 1031(f) does not preclude the benefits of Section 1031 in the case of a series of transactions between related parties if each transaction in the series qualifies under Section 1031(a), and none of the parties receive more than a property to Affiliate, Related Party would enter into a deferred exchange agreement with a QI providing for the Related Party's exchange of Affiliate RP that it transfers to Affiliate. All potential Related Party replacement properties will be owned by parties unrelated to OP-Taxpayer, Affiliate, and Related Party.

The IRS ruled that Sections 1031(f)(1) and (f)(4) did not apply to disqualify OP-Taxpayer from the benefits of Section 1031 in its exchanges with related parties provided that (1) each related party transferring replacement property into the exchange in State of the Art in Like Kind Exchanges, 2012? Among those rules were a frequently encountered pair of questions relating to partnerships and Section 1031 transactions, whether (1) a taxpayer can exchange property received in a distribution from a partnership (a "drop and swap"), and (2) whether a taxpayer who receives replacement property in an exchange can immediately transfer the property to a partnership (a "swap and drop"). Both transactions have been targeted by both the IRS and state tax authorities, but recently there has been some noteworthy develop-ments at the state level relating to "swap and drop" transactions. The main challenge that has been raised with respect to both transactions comes from the language of Section 1031(a)(1) which requires that both relinquished property and replacement property be held for productive use in a trade or business or for investment in a trade or business. In State of the Art in Like Kind Exchanges, 2012, we discussed various revenue rulings issued by the Service attacking "swap and drop" and 'drop and swap' transactions on this basis and how the Service's attacks have been consistently rejected in cases like Magneson, 753 F.2d 1490, 55 AFTR2d 85-911(CA-9, 1985), affg 81 TC 767 (1985), Maloney, 95 TC 89 (1989), and Bolker, 760 F.2d 1059, 56 AFTR2d 85-5121 (CA-9, 1985), affg 81 TC 782 (1985). We also discussed the Tax Court's more recent decision in Sandmeyer, TCM 2000-189, where, in the Section 1033 context, the Service had succeeded in challenging a transaction.

The Eighth Circuit thus expanded the domain of the anti-abuse rule in Section 1031(f)(4), beyond what was intended by Congress, to cover any transaction in which a related party enjoys a benefit prohibited to the taxpayer engaging in a Section 1031 exchange.

minimal amount of non-like-kind property. In the facts of this ruling, Parent-REIT was the sole general partner and 95.5% owner of the Operating Partnership (OP-Taxpayer). OP-Taxpayer had a 99.999% interest in a limited partnership (Affiliate) in which the other 0.01% was held by a taxable REIT subsidiary (IRS-Holding), which was a corporation wholly-owned by OP-Taxpayer. OP-Taxpayer also owned 99% percent of a LLC (Related Party) in which the other 1% was owned by a corporation (Subsidiary) wholly owned by Parent-REIT.

OP-Taxpayer engaged in a deferred like-kind exchange through a QI and a qualified trustee under an exchange agreement and a qualified exchange trust agreement, and pursuant thereto, conveyed its relinquished property to an unrelated buyer; and timely identified and acquired a replacement property owned by Affiliate (RP). Affiliate entered into an exchange agreement and a qualified exchange trust agreement to facilitate the exchange of RP for like-kind replacement property (Affiliate RP). To the extent any Affiliate RP was acquired from Related Party, prior to the transfer of such changes is also engaging in its own separate and compliant like-kind exchange and receives non-like-kind property equal to no more than 5% of gain realized, and (2) OP-Taxpayer, Affiliate, and Related Party hold their replacement properties for at least two years after the date of the last transfer of property in the exchanges.

In addition, the parties also requested a ruling on the manner in which the identification and replacement period rules applied. The IRS ruled that OP-Taxpayer, Affiliate, and Related Party each must be regarded as undertaking its own exchange transaction with an identification and replacement period that would apply separately to that party's exchange, commencing on the date of the respective party's initial transfer of relinquished property. Each transfer of relinquished property in each separate exchange would result in a separate application of the limits on identification of multiple or alternative replacement properties.

**SWAP AND DROP**

The rules applicable to exchanges involving partnerships were extensively

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8 Id. at 279-281.
similar to a swap and drop, when the Service’s challenge had been based on a step transaction argument. How these transactions had been challenged in state court and in California in particular was explored.

In two notable (although non-precedential) cases involving “swap and drop” transactions, the California State Board of Equalization (CSBE) sustained a taxable determination.

In Appeal of Aris, Appeal No. 464475, the taxpayers were partners in a limited partnership that owned and operated apartments located in San Francisco. Under threat of eminent domain, the partnership sold the apartments to the City and County of San Francisco. The taxpayers elected to defer capital gain realized on the sale under Section 1033(a)(2). As one of its replacement properties, the partnership acquired an interest in rental real property located in Scottsdale, Arizona. The Scottsdale property was jointly purchased by the partnership and three other parties. Immediately after the purchase transaction, the purchasing parties contributed the Scottsdale property to a newly formed Arizona LLC, which engaged in the business of owning, leasing, operating, and maintaining the property. In exchange for its interest in the property, the partnership received an interest in the Arizona LLC.

The California Franchise Tax Board (FTB) applied the step transaction doctrine and determined that the partnership’s purchase of the interest in the Scottsdale property “was formulaic and transitory” and that the partnership entered into the transaction with the intention of acquiring a membership interest in the Arizona LLC. Accordingly, the FTB collapsed the steps taken and treated the transaction as if the partnership acquired a membership interest in the Arizona LLC, which did not qualify as replacement property under Sections 1051 and 1053. The FTB cited Sandowal for the proposition that an exchange will not qualify for nonrecognition even if the replacement real property is acquired first, when there was a prior agreement to transfer the property to a partnership.

The taxpayers in Aris argued that the interest in the Scottsdale property acquired by the partnership was qualified replacement property and that the conveyance of that interest to the Arizona LLC was not a disqualifying event. In support of their position, the taxpayers cited Magneson, contending that the FTB mischaracterized the transaction as an exchange of a partnership interest and that the partnership exchanged a fee interest in the apartments for an undivided interest in the Scottsdale property, followed by a capital contribution to the Arizona LLC. The taxpayers further cited the opinion of the Oregon Tax Court in Marks v. Dept. of Revenue, TCMD 050715D (7/24/07) to support the position that Magneson was not overruled by the enactment of Section 1051(a)(2)(b)(D) in 1984.

By a 5–2 vote, the CSBE sustained the FTB’s determination that the taxpayers’ “swap and drop” transaction did not qualify under Sections 1051 and 1053. Certain members of the CSBE distinguished Magneson in that the court specifically limited its holding to circumstances where the acquired property was transferred into a partnership in which the taxpayers were general partners; as general partners, the taxpayers maintained ownership and control of the property. Conversely, the only right maintained by the taxpayers in Aris with respect to the Scottsdale property after it was contributed to the Arizona LLC was a veto power to prevent a sale.

In Appeal of Marcil, Appeal No. 458852, the husband and wife taxpayers were limited partners in a California limited partnership (HVA) formed to hold and manage certain real property located on North Vista in Los Angeles (the Vista Property). The husband also owned a membership interest in an LLC (MD), formed to acquire and develop certain real property located on Manchester Boulevard in Los Angeles (the Manchester Property). In 2001, HVA entered into an exchange agreement with a QI to sell the Vista Property and acquire replacement property. The QI organized a single-member LLC (Lava Rock) to acquire the Manchester Property as the replacement property, which on acquisition was held 60% by Lava Rock and 40% by MD. Thereafter, the QI transferred to HVA its membership interest in Lava Rock, which HVA assigned to the husband eight days later. Two weeks later, the husband transferred the Lava Rock interest to MD. At the end of 2001, HVA filed a certificate of dissolution with the California Secretary of State.

The FTB determined that HVA did not complete a like-kind exchange by acquiring the 60% interest in the Manchester Property because it quickly distributed the property and terminated its legal existence. For that reason, HVA failed to meet the “holding” requirement of Section 1051 and thereby effected a disqualifying “swap and drop” transaction. In their appeal to the CSBE, the taxpayers cited Bolker and Maloney for the position that a swap and drop transaction qualifies under Section 1051. Conversely, the taxpayers argued that HVA continued to hold the Manchester Property because a deemed merger occurred between HVA and MD when Gerald contributed his interest in Lava Rock to MD immediately after receiving it from HVA, in substance leaving HVA as the surviving partnership for tax purposes because its assets exceeded those of MD. By a 5–2 vote, the CSBE sustained the FTB position.

However, in a recent case, Appeal of Rayo Development Corporation, Appeal No. 735761 (6/25/15), the CSBE appears to
have changed course on the "swap and drop" fact pattern. In this case, two parties exchanged their separate properties for joint interests in a common property. Seven months later, but in a subsequent tax year, the parties dropped the common property into a partnership. The parties did not have an agreement between one another to drop the property into a partnership; however, they did have an agreement with the bank providing purchase financing for the transaction requiring that the property be contributed to the partnership within a year.

The CSBE approvingly cited the litany of cases rejecting the argument that the "held for" requirement was not satisfied. It did not view the step transaction doctrine as applying because "there was no indication that appellants artificially structured the transaction by adding unnecessary or meaningless steps" and because the "acquisition of the property had real economic substance and legal significance, regardless of whether appellants later contributed the property to an LLC, as provided by the loan agreement, or refinanced the property before it was contributed to an LLC." The CSBE pointed out that the Tax Court has often declined to apply the step-transaction doctrine in cases similar to Rago, in which the "acquisition of the property exposed appellants to real economic risks and conversely entitled appellants to any appreciation in the value of the property or income from the property." In other words, even though the property was held jointly for less than a year, the fact that during that time the parties were exposed to fluctuations in the property's value and the parties were entitled to and in fact collected income from the property, the ownership for that period has real economic substance and should not be disregarded.

The key question here is how the 5-0 vote of the CSBE will change the landscape in California (where mar-ginal tax rates are very significant). Rago should be considered precedent, whereas the prior cases were not, and should put the "held for" issue to bed in California at least in situations where some time has passed between the swap and the drop. However, Rago still might not apply in cases in which the drop occurs too soon. Moreover, Rago arguably reduces the risk to California taxpayers in "drop and swap" transactions when a partnership distributes property to partners prior to their undertaking separate exchanges or sales, but since it does not directly dispose of other challenges to drop and swaps, the degree of the change of course in thinking represented by Rago, and its broader potential impact in California, remains in question.\(^9\)

**Step Transaction**

The cases that have identified step-transaction as a doctrine potentially applicable to swap and drops, have been successful in doing so only using an attack based on Section 1031(a)(2)(D), which provides that an interest in a partnership cannot be like-kind property. The argument is that under step-transaction principles, a swap and drop is really an exchange of the relinquished property for an interest in the partnership into which the replacement property is dropped. This argument has gained some traction with respect to transactions similar to the following example.

A owns property X and B owns property Y. X and Y are of like kind to a third property, Z. Separately, A and B swap their respective interests in X and in Y in exchange for Z, with each of A and B receiving a 50% interest in Z and owning Z as joint-tenants (or tenants in common). Afterwards, A and B drop Z into a partnership, P, with each receiving 50% of the interests in P.

In this circumstance, the argument has been that the "transitory" ownership of property Z in joint tenancy should be disregarded and A and B should be treated as transferring X and Y, respectively, in exchange for interests in P. So recast, the transaction is no longer a like-kind exchange because, as indicated above, a partnership interest is not eligible to be like-kind property.

It is the authors' opinion that the application of the step-transaction doctrine to these facts is unsupportable because it fails the doctrine's fundamental requirement that there be a plausible alternative transaction that could have been accomplished using less steps. The authorities that have applied step-transaction have claimed that the joint ownership in the replacement property that exists before the drop into the transaction is transitory and it should therefore be disregarded. However, these authorities fail to explain how the partnership got the replacement property in the first place. In other words, even conceding that the parties exchanging their properties really are exchanging the properties for partnership interests, there is no explanation for when and how the partnership transacted to receive the replacement property.

The owners of two separate properties would be treated as contributing their respective properties to a partnership, after which the partnership is treated as swapping the properties for the replacement property. The transaction so recast is a standard drop and swap, which has been upheld as a Section 1031 transaction by the Ninth Circuit, the Tax Court, and other authorities.\(^12\) Therefore, although as a practical matter, taxpayers engaging in Swap and Drop transactions should be wary of the application of the step-transaction doctrine, in the opinion of the authors there is substantial grounds to argue that the step-transaction doctrine should not apply.

**Practical Advice**

Most courts have not accepted the IRS's contention that these transactions are impermissible, and California, an important holdout, appears to have now joined those courts as well. This is a significant development, given that it is California and in light of the state's high marginal state income tax rates. Although it is the opinion of the authors that the step-transaction doctrine is inapplicable to

\(^9\) The authors thank Lou Weiler of Weiler Partners LLP for his insights on California matters.

\(^12\) See, e.g., 760 F.2d 1029 (9th Cir. 1982) (CA-9, 1982).

\(^{16}\) BIR 81 TC 782 (1983).
cases like Arias, Muriel, and Rago, California's seeming change of heart in Rago does not expressly disclaim the application of the step-transaction doctrine, making it important for taxpayers to be wary of certain step-transaction pitfalls. For example, a binding commitment entered between parties to a swap and drop, agreeing to contribute replacement property to a partnership, or failing to (1) legally convey property, (2) pay transfer tax, if any, or (3) obtain lender consent may whet the IRS's or the SBE's appetite for a step-transaction doctrine based challenge. However, mistakes of that nature are avoidable with care in planning. What is left are the IRS's litigation-related Revenue Rulings (which are suspect) and some cases that point out the stumbling blocks. It is doubtful to what degree, if any, the IRS still opposes these transactions in light of their well-known commonplace use, assuming the transaction is properly executed. Thus, although there is still some risk in undertaking them, the weight of the law increasingly supports such transactions.

UNDERWATER PROPERTY

In the previous "state of the art" installment, in light of the economic downturn, numerous issues were discussed that arise with respect to property encumbered by debt in an amount exceeding the fair market value of the property (said to be "underwater"). One issue was whether underwater property can be the subject of a like-kind exchange because the owner has no equity in the property. The better view of the matter continues to be that "phantom gain" arising from a foreclosure should qualify for nonrecognition under Section 1031 just like any other gain from the conveyance of property. Although there continues to be no direct authority on this issue, the IRS issued a ruling consistent with this treatment of phantom gain under Section 1031.

In Ltr. Rul. 201551009, Taxpayer's disregarded LLC owned a building complex subject to a non-recourse mortgage on which it was underwater. Taxpayer negotiated an agreement with the mortgage holder to transfer the complex to the holder in satisfaction of the mortgage. Taxpayer then found replacement property with a value equal to the outstanding amount of the non-recourse mortgage. Taxpayer transferred both the right to transfer the complex to the mortgage holder and the right to acquire the replacement property to a QI. The IRS ruled that the transfer of the right to transfer the complex to the mortgage holder was a good transfer of relinquished property under Section 1031, even though the complex was underwater. In other words, the IRS ruled that there could be a good Section 1051 exchange even though Taxpayer had no equity in the complex and even though the cash for the acquisition of the replacement property would be supplied by Taxpayer and not with proceeds from the relinquished property.

EXCHANGES OF INTANGIBLES

Under Reg. 1.1051(a)–2(c), intangible personal property is of like-kind to other intangible personal property only if (1) the nature or character of the rights involved are of like-kind (e.g., a patent is of like-kind to a patent and a copyright is of like-kind to a copyright), and (2) the nature or character of the underlying property to which the intangible personal property relates is of like-kind. For example, an exchange of a copyright on a novel for a copyright on a different novel is a like-kind exchange, but an exchange of a copyright on a novel for a copyright on a song is not.

Recently, in Ltr. Rul. 201551009, the IRS ruled on the exchange of manufacturing and distribution contracts between taxpayers. Taxpayer had two types of agreements: the Dual Activity Agreements and the Single Activity Agreements. Under the Dual Activity Agreements, Taxpayer had rights to manufacture and distribute a group of products that were nondepreciable tangible personal property of various different brand names (Product A). Under the Single Activity Agreements, Taxpayer had rights to distribute a different group of products of various different brand names (Product B).

Subsidiary, a wholly owned subsidiary of Company, also had two types of agreements: Replacement Dual Activity Agreements, to manufacture and distribute Product A, and Replacement Single Activity Agreements, to distribute Product B. These agreements had the same set of counterparties as Taxpayer's agreements. The substantial difference between Taxpayer's agreements and Subsidiary's agreements was that Subsidiary's agreements were the territory in which they authorized manufacture and/or distribution. There were other differences between the agreements such as the durations, renewable periods, quality control provisions, marketing activity obligations, restrictions on manufacturing and distribution of similar products, and termination events. Nevertheless, the Taxpayer's exchange of the Dual Activity Agreements for the Replacement Dual Activity Agreements (the Dual Agreements) and of the Single Activity Agreements for the Replacement Single Activity Agreements (the Single Agreements) were upheld as like-kind exchanges based on the following:

- Although manufacturing and distribution are generally two distinct business activities, resulting in the rights to each to not be of a like-kind—within respect to the Dual Agreements the manufacturing and distribution of Product A were historically and economically intertwined, and performed best by a single entity, that the overall right to manufacture and distribute was viewed as a single right for like-kind exchange purposes.
- Although certain terms of the Dual Agreements and of the Single Agreements differed, they were substantially similar, with the Dual Agreements granting the rights to manufacture and distribute Product A and the Single Agreements granting the rights to distribute Product B.
- The products manufactured and distributed under the Dual Agreements were like-kind and the
products distributed under the Single Agreements were like-kind.

**Goodwill**

It is important to highlight that Reg. 1.1051(a)-2(c)(2) provides that goodwill or going-concern value of a business is not of a like-kind to the goodwill or going concern value of another business. In CCA 200911006, the IRS concluded that intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property under Section 1051; however, the description of goodwill and going concern value itself remained elusive.

The Court of Federal Claims recently weighed in on the manner that goodwill and going concern value should be identified and valued in Desert Management Corp., 112 AFTR2d 2013-5550 (Fed. Cl. Ct., 2013). The IRS disputed the taxpayer’s contention that no goodwill was transferred in an exchange of an operating country radio station intended to qualify under Section 1051. Contending that no goodwill was transferred, the taxpayer relied on Meredith Broadcasting Co., 405 F.2d 1214, 22 AFTR2d 5987 (Cl. Ct., 1968), which had stated that a radio station does not have goodwill. Additionally, the taxpayer argued that “goodwill” should be understood to mean the cause for a “rate of return on investment which is above normal returns in the industry and limits it to the residual intangible asset that generates earnings in excess of a normal return on all other tangible and intangible assets [citations omitted]” and that therefore, an enterprise must have above average profits or, at least, the enterprise must be profitable to have goodwill. Based on those criteria, the taxpayer argued that it was entitled to attribute all value above its tangible and intangible assets to its FCC license, not to goodwill. The court rejected the argument that radio stations could not have goodwill. Nevertheless, the court found that the expert reports offered by the IRS backfired, because they were consistent with the taxpayer’s contention that the radio station had negligible goodwill.

**TRANSFERS OF PROPERTY TO RICs AND REITs**

Reg. 1.357(d)-7 generally provides that if property of a C corporation becomes the property of a RIC or REIT either by the qualification of that C corporation as a RIC or REIT or by the transfer of assets of that C corporation to a RIC or REIT, then the RIC or REIT will be subject to tax on the net built-in gain in the converted property under the rules of Section 1374 and the regulations thereunder, as if the RIC or REIT were an S corporation.

Commentators expressed concern that this general rule may inappropriately capture property transferred in certain exchanged-basis transactions, including like-kind exchanges. In these transactions, the C corporation transferor replaces property it transferred to a RIC or REIT with property that has an equivalent basis and built-in gain, and as a result, the built-in gain remains subject to corporate tax in the hands of the transferor. Therefore, there would not be any circumvention of the repeal of the General Utilities doctrine, which usually requires corporations to recognize gain or loss on the distribution of property. Furthermore, Reg. 1.357(d)-4(b)(5) already provided an exception in an analogous context (where a C corporation transfers all or substantially all of its assets to a tax-exempt entity) to the extent the transfer qualifies for nonrecognition treatment under Section 1051 or 1035.

Addressing these concerns, Treasury and the IRS issued proposed amendments to Reg. 1.357(d)-7 in 2012 to provide an exception for a transfer of property by a C corporation to a RIC or REIT to the extent that the transfer qualifies for nonrecognition treatment under either Section 1051 or 1035. On 8/2/15, the IRS issued final regulations concerning transfers of property from a C corporation to a RIC or REIT, adopting the proposed regulations. Thus, Reg. 1.357(d)-7(d)(5) now provides that the general rule of the section “does not apply to a conversion transaction to the extent that a C corporation transfers property with a built-in gain to a RIC or REIT, and the C corporation’s gain is not recognized by reason of either section 1051 or 1035.”

**CONCLUSION**

As has been the case for decades, a continual stream of guidance from Treasury, the IRS, and the courts continues to ensure that this area of the tax law is in no danger of becoming static. The danger to be found is instead in the Obama Administration’s current proposed changes to Section 1051 to limit the deferral on real property to an annual $1 million dollar cap on capital gain. Treasury’s authority to implement the provision would include rules aggregating multiple properties exchanged by related parties. In addition, the current proposal would make art and collectible investments ineligible for nonrecognition treatment under Section 1051. Although the current proposal does not completely eliminate Section 1051 (which has also been tossed around recently), it comes very close.

While it is impossible to determine the legislative fate of Section 1051, one thing is quite likely—the tax revenues that politicians expect (or merely promise?) to reap by enacting such limitations on, or even repealing, Section 1051 will not materialize as expected. As a prefatory matter, taxpayers will be more inclined to continue to hold onto assets with unrealized gain instead of triggering the recognition of gain. More importantly, tax practitioners will provide alternative solutions to like-kind exchange transactions. Politicians, and our Congress, never appear to grasp this concept or pretend not to? no matter how many times this happens, which puts the fate of Section 1051 in real limbo and promotes the expeditious use of Section 1051 like-kind exchanges before the long-standing rules are modified.