

ANNUAL UPDATE: SUMMARY OF RECENT DEVELOPMENTS UNDER SECTION 1031

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Introduction

This annual update covers Section 1031 cases, rulings and other developments from May 2002 through March 2003. During this period, only one Section 1031 case was decided, and it arcanelly involved water rights and the like-kind issue. A District Court in Arizona held that water rights limited in quantity, use, and priority and to a 50-year duration were not of like kind to a fee interest in farm land. Wiechens v. United States, 2002 TNT 214-8 (D.C. Az. 2002). The taxpayer argued that, even if the water rights were limited to a 50-year duration, they were interests in real estate and equivalent to a leasehold of a fee for 30 or more years which may be exchanged for a fee under Treas. Reg. Section 1.1031(a)-1(c)(2). But the court rejected this analogy. Applying the test set forth in Koch v. Commissioner, 71 T.C. 54, 65 (1978), the court found that the relinquished water rights were narrowly restricted as to quantity, use and priority, unlike a fee interest in farm land or a long-term leasehold of a fee. Wiechens reinforces the principle that, at least where limited interests in real estate are involved, “not every exchange of real property interests meets the section 1031 like-kind requirement.” Smalley v. Commissioner, 116 T.C. 450 (2001) (involving 2-year timber cutting rights for fee interests, but case decided on other grounds).

One Revenue Ruling was issued concerning related party exchanges. The IRS ruled that a taxpayer relinquishing low-basis property to a qualified intermediary (QI) in a deferred exchange for high-basis replacement property owned by a related party must recognize gain under Section 1031(f)(4) if the related party receives cash or non-like-kind property. Rev. Rul. 2002-83, 2002-49 I.R.B. 927. The IRS previously issued technical advice memorandums (TAMs) addressing similar fact patterns in simultaneous exchanges. The IRS has now confirmed that the same analysis applies to a deferred (or “delayed”) exchange. Key facts in the Revenue Ruling included: (1) clear shifting of basis; (2) a prearranged agreement to acquire the replacement property before the relinquished property was transferred; and (3) the related party’s receipt of cash upon the sale of the replacement property to the QI. The related party received the same sales proceeds received by the QI from the transfer of the relinquished property to an unrelated buyer. Viewed as one economic group, the related parties cashed out of the investment in the

relinquished property in the two-year period. The last fact (the related party's receipt of cash) appeared to be the most critical one to the holding of the Revenue Ruling that Section 1031(f)(4) applied to the taxpayer's deferred exchange.

For many years, we have written about related party exchanges and cautioned that exchanges in which a taxpayer receives replacement property owned by a related party are presumptively taxable under Section 1031(f)(4) if the related party receives cash or non-like-kind property. It does not matter whether the exchange is simultaneous or deferred, whether or not a QI is used, or whether the exchange is directly between related parties or involves a related party as the seller of the replacement property. Even after the issuance of Rev. Rul. 2002-83, we suspect that some taxpayers will continue to engage in these transactions, like motorcyclists racing in the rain without helmets. The "thrill" of acquiring replacement property from a related party is too alluring for some taxpayers. Such transactions are also motivated by practical considerations and business exigencies, including meeting the 45-day identification requirement and ensuring that replacement property is in fact acquired during the exchange period. In our detailed discussion of this Revenue Ruling, we suggest an alternative. Consider a separate Section 1031 exchange by the related party rather than the related party receiving cash or non-like-kind property on the transfer of the replacement property. By its terms, Rev. Rul. 2002-83 only applies where, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

One Revenue Procedure was issued concerning the elective classification of non-corporate entities, such as partnerships and limited liability companies (LLCs), which are solely owned by a husband and wife as community property. Rev. Proc. 2002-69, 2002-45 I.R.B. 831. Although Rev. Proc. 2002-69 was issued under Section 7701 and does not mention Section 1031, it has relevance to certain Section 1031 exchanges by a husband and wife and non-corporate entities wholly owned by them as community property. Under the Revenue Procedure, a husband and wife who solely own such an entity as community property (not as separate property) may elect to treat the entity as a disregarded entity (in the same way as a single-member LLC). Alternatively,

they may elect to treat the entity as a partnership and file appropriate partnership returns. A change in reporting position will be treated as a conversion of the entity. The Revenue Procedure is effective on November 4, 2002.

The Revenue Procedure alleviates problems encountered when the relinquished property is owned by a husband and wife and a lender requires that a single-asset bankruptcy-remote entity, such as an LLC, own the replacement property. These problems can now be avoided where a qualified entity (such a partnership or LLC, but not a corporation) is solely owned by the husband and wife as community property and is treated as a disregarded entity. If the entity is owned by a husband and wife as separate property, the problems remain since Rev. Proc. 2002-69 only applies to ownership by a husband and wife as community property. In such situations, married taxpayers are often forced to use costly and complicated structures to meet a lender's single-asset-entity requirements. These structures include (if permitted by the lender) co-ownership of the replacement property by two single-member LLCs or other disregarded entities (one owned solely by the husband and one owned solely by the wife). Although it is limited to ownership of a qualified entity as community property, Rev. Proc. 2002-69 is a useful first step in obviating the need for such structures in what should be simple exchanges by married persons. The Revenue Procedure is discussed further below.

In a very interesting private letter ruling (PLR), the IRS approved a reverse, build-to-suit exchange involving land leased from a related party. PLR 200251008. The replacement property consisted of a newly-created 32-year sublease from a related party and improvements constructed by an exchange accommodation titleholder (EAT) within the 180-day period set forth in Rev. Proc. 2000-37, 2000-4 I.R.B. 308. The exchange used the "exchange last method" and was consummated as a four-party simultaneous exchange involving the taxpayer, a QI, an unrelated buyer of the relinquished property, and the EAT as the transferor of the replacement property. The exchange was completed before the end of the 180-day period after the EAT acquired the 32-year sublease. No issue arose as to the "sufficiency of identification" of the improvements under Treas. Reg. Section 1.1031(k)-1(e)(1) since the exchange was simultaneous.

The ruling is especially noteworthy because of the newly-created 32-year sublease on a portion of land leased by a related party from a city. The related party was already developing and constructing the infrastructure required so that the taxpayer could relocate its business to the land. The new sublease between the related party as lessor and the EAT as lessee provided for market rent for the unimproved land. After the EAT entered into the sublease, the EAT constructed improvements in the 180-day period, using the related party as construction manager and loan proceeds from the taxpayer. The sublease and improvements were then transferred from the EAT to the QI and from the QI to the taxpayer to complete the exchange in the 180-day period specified in Rev. Proc. 2000-37. Since the sublease had a term of more than 30 years, the IRS stated that the sublease and improvements were of like kind to a fee interest in the relinquished property, citing Treas. Reg. Section 1.1031(a)-1(c)(2).

In a footnote, the IRS stated that Section 1031(f) does not apply to this transaction because “both the Taxpayer and the related parties continue to be invested in the exchange properties, and are not otherwise cashing out their interest.” Further, the IRS stated that Section 1031(f)(1) “is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that was part of the exchange.” The ruling implies that the related party’s granting of a new lease under these circumstances (e.g., at a market rental rate, without prepaid rent or capital value in the lease) is not a sale, exchange or other “disposition” for purposes of Section 1031(f).

The IRS also did not question the transaction applying judicial doctrines and the principles of Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951) (exchange of property for construction services and new building on other land owned by the taxpayer did not qualify under Section 1031) and Rev. Rul. 76-390, 1976-2 C.B. 243, and Rev. Rul. 67-255, 1967-2 C.B. 270 (improvements on land already owned by taxpayer held not to be like-kind replacement property to land under Section 1033). If the sublease were disregarded on business purpose, substance-over-form, step-transaction or other grounds, the exchange would be vulnerable to attack as an exchange of property for construction services or other non-like-kind

property (improvements alone on land already owned by the taxpayer through a related party). By using a newly-created 32-year sublease from a related party, it may be argued that the taxpayer in PLR 200251008 did indirectly through a related party what it could not do directly under Bloomington Coca-Cola Bottling Co. But the IRS did not raise this issue and respected the new 32-year sublease from the related party for purposes of Section 1031.

Five private letter rulings were issued on like-kind exchange programs (LKE Programs) using a master exchange agreement and a single QI. The rulings involved mass exchanges of leased vehicles, equipment and other tangible depreciable personal property. PLRs 200242009, 200241016, 200241013, 200240049 and 200236026. Those who are primarily involved with real estate exchanges should not overlook these rulings since they clarify some generally applicable issues. Further, the rulings on LKE Programs may just as easily apply to a LKE Program involving mass dispositions of real estate held for rental or investment purposes.

The rulings on LKE Programs may be mined for other little gold nuggets contained therein, such as creating separate and distinct exchanges by matching (at least within the 45-day identification period); using anticipatory, blanket assignments in a master exchange agreement; sending written notice of an assignment by email (at least where emails are digitally stored on a secure data base); loaning funds to a purchaser of relinquished property in a separate loan transaction without creating boot; and converting receivables and payables held by a QI into cash at face value (presumably including a buyer's installment note) without violating the safe harbors. Due to the volume of PLR requests for LKE Programs, some commentators, including former IRS officials, have written to the IRS and proposed a revenue procedure for LKE Programs. These rulings and the proposed revenue procedure are discussed further below.

One TAM was issued that narrowly interpreted the "underlying property" in a television license to its assigned frequency of the electromagnetic spectrum in accordance with a prior TAM. TAM 200224004. See also TAM 200035005. Thus, the IRS ruled that the value of the television license received in exchange for radio licenses did not include television network

affiliation rights, as the taxpayer had contended. The taxpayer claimed that the ability to affiliate with a major television network was not attributable to its existence as a separate asset but was inherent in the television license itself. The IRS rejected this argument and stated that the appropriate manner of identifying the “underlying property” is to look to the license itself and the license merely authorized the use of the radio transmitting apparatus.

A prior TAM approved an exchange of a radio license for a television license, finding the licenses to be of like kind under Treas. Reg. Section 1.1031(a)-2(c)(1). TAM 200235005 (5/11/00). The TAM examined (1) the nature or character of the rights involved (finding the rights conferred on an FCC licensee to be basically the same, despite differences regarding the specific terms and conditions of operation with respect to radio and television licenses); and (2) the nature or character of the underlying property (finding the “underlying property” to be the assigned frequency of the electromagnetic spectrum referred to in each license). The TAM did not view the “underlying property” as the entire array of assets of a radio or television station or even as the tangible personal property referred to in the licenses, such as transmitters, towers and antenna, which are described in the same Product Class in the SIC Manual. The TAM noted that the FCC license principally relates to the use of the radio transmitting apparatus, rather than the apparatus itself. Although radio and television broadcasts are assigned to different frequency bands, television broadcasts require a considerably larger bandwidth and a licensee would be in violation of its license if it used a television frequency to broadcast radio transmissions and vice versa, the TAM found these to be merely differences in grade or quality. The TAM stated that “even the narrowest interpretation of the like kind standard does not require that one property be identical to another or that they be completely interchangeable.” See also McBurney, “New IRS Ruling on Swap of Intangibles - FCC Radio and TV Station Licenses Are Like-Kind Property,” Journal of Taxation 290 (November 2000). Due to the specialized nature of these TAMs involving FCC licenses, we do not discuss them further below.

One field service advice (FSA) was issued in which the IRS concluded that the doctrines of business purpose, step transaction and substance over form could be used to disregard an

exchange designed to shift the basis of exchanged aircraft and accelerate depreciation. FSA 200244010. The taxpayer purchased and leased back a new airplane to a foreign airline. Due to the lease to a foreign person, the taxpayer would have been forced to depreciate the cost basis of the new plane using the alternative depreciation system (ADS) in Section 168(g) (straight-line depreciation over a 12-year class life). After the purchase and leaseback, however, the taxpayer exchanged the new plane for eight, substantially depreciated, domestic aircraft owned by a subsidiary. The taxpayer's cost basis of the new plane was then shifted under Section 1031(d) to the eight old aircraft, and the taxpayer claimed accelerated depreciation on the domestic aircraft over a 7-year recovery period under MACRS. The transactions occurred before 1995 and predated Treas. Reg. Section 1.168(h)-1 (which prevents such basis freshening using a like-kind exchange) and Treas. Reg. Section 1.1502-80(f) (which provides that Section 1031 does not apply to intercompany transactions by members of a consolidated group of corporations). The IRS concluded that judicial doctrines allow the IRS to disregard the Section 1031 exchange, thereby achieving the same result as provided in Treas. Reg. Section 1.168(h)-1. The FSA cited the recent case of True v. United States, 190 F.3d 1165 (10th Cir. 1999), which applied the business purpose and step transaction doctrines to disregard a Section 1031 exchange and prevent a taxpayer from effectively depleting the cost basis of non-depletable, recently-purchased ranch land. True and these judicial doctrines were discussed extensively in Phillips & Rocca, "Summary of Recent Section 1031 Cases, Rulings and Advices" (13th Annual NRDC Conference) (April 27, 2000) at 13-17. The FSA is not discussed further below.

In other recent developments, Treasury and the IRS issued final tax shelter disclosure and list maintenance regulations that narrow the scope of reportable transactions under Sections 6011 and 6112. Under Rev. Proc. 2003-25, 2003-11 I.R.B. 1, Section 1031 exchanges are now exempt from reportable transactions that generate significant book-tax differences. The proposed regulations would have required disclosure of Section 1031 exchanges that generated \$10 million of book income as a reportable transaction, while exempting involuntary conversions under Section 1033. Since most like-kind exchanges are deferred exchanges using a QI, they are typically recorded as "monetary exchanges" and treated as sales for GAAP purposes, thereby

creating a book-tax difference. Even if they create a significant book-tax difference, like-kind exchanges are now exempt from the reporting rules as long as taxpayers file Form 8824 and comply with the reporting requirements under Section 1031.

Treasury agreed with commentators that the IRS could amend Form 8824 if it needed more information. Thus, disclosure through a modified Form 8824 was preferred over including Section 1031 exchanges as reportable transactions. In particular, one commentator suggested that Question 7 of Form 8824 dealing with related party exchanges could be changed to require additional disclosure and prevent potential abuse in light of Rev. Rul. 2002-83 and prior TAMs. Question 7 now only asks “Was the exchange made with a related party (see instructions)?” Question 7 could be expanded to read “Was the replacement property in the exchange acquired directly or indirectly from a related party?” See letter dated December 6, 2002 from Stephen M. Renna of the Real Estate Roundtable to the IRS enclosed with the Program Materials.

A House Bill has been introduced that would convert Section 1031 into an elective 180-day rollover provision. See Section 203 of H.R. 22, Individual and Small Business Tax Simplification Act of 2003, enclosed with the Program Materials. This follows earlier proposals for simplification of Section 1031 made by the Joint Committee on Taxation in 2001 and Treasury in 1997. It is unclear whether any statutory changes will be enacted to Section 1031 because Section 203 of H.R. 22 is a small component of a far-reaching bill. But administrative simplification by the IRS continues to be a consistent theme under Section 1031, and statutory changes could follow this trend. See Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, JCS-3-01 (April 25, 2001), 2001 TNT 90-39 (“The Joint Committee staff recommends that a taxpayer should be permitted to elect to rollover gain from the disposition of appreciated business or investment property described in Section 1031 if like-kind property is acquired by the taxpayer within 180 days before or after the date of the disposition (but not later than the due date of taxpayer’s income tax return). The determination of whether properties are considered to be of a ‘like-kind’ would be the same as under present

law.”); Department of the Treasury, Taxpayer Bill of Rights 3 and Tax Simplification Proposals, April 1997 (April 16, 1997), 97 TNT 74-9 (“The proposal would make four changes to the deferred exchange rules. The first change would simplify the treatment of deferred exchanges by replacing the exchange requirement with elective rollover treatment. A taxpayer would have until the later of 180 days, or when the taxpayer’s return for the year is due, to acquire replacement property. To further simplify the rules, the present-law 45-day limit on identifying replacement property would be repealed.”).

A late-breaking development is a new PLR on undivided fractional interests in rental real estate. We are informed that the IRS issued a favorable ruling for a co-ownership arrangement under Rev. Proc. 2002-22, 2002-14 I.R.B. 1, but the ruling has not yet been published. Rev. Proc. 2002-22 was discussed extensively in last year’s program and provides detailed guidelines for ruling requests on tenancy-in-common interests in rental real estate. See Phillips and Rocca, “Summary of Recent Developments Under Section 1031” (15th Annual NRDC Conference) (April 25, 2002) at 5-33 and Appendix A; Jelsma and Steinhouse, “The TIC: Tax Planning Opportunity or Bloodsucking Parasite” (15th Annual NRDC Conference) (April 25, 2002); Weller, “Real Estate Undivided Fractional Interest Programs and Revenue Procedure 2002-22” (15th Annual NRDC Conference) (April 25, 2002). Undivided fractional interests will also be discussed by several panels in this year’s program.

Finally, significant developments have occurred at the state level affecting Section 1031 exchanges. In addition to nonresident individuals and certain non-California entities, California now imposes tax withholding of 3 1/3% of the full sales price when *resident individuals* dispose of California real property at a gain and the transfer occurs on or after January 1, 2003. See California Revenue and Taxation Code Section 18662(e); California Forms 593-C, 593-L, 593-W and Instructions. Exceptions are provided if the total sales price, before applying the transferor’s percentage of ownership, is \$100,000 or less; the property qualifies as the transferor’s principal residence under Section 121; the transfer is pursuant to a judicial or nonjudicial foreclosure or by a deed in lieu of foreclosure; the transfer is in connection with an involuntary conversion and the

transferor intends to acquire replacement property under Section 1033; the transfer is part of a simultaneous or deferred exchange under Section 1031 “but only to the extent of the amount of the gain not required to be recognized for California income tax purposes” (see below); and installment sales where the buyer agrees to withhold on each payment instead of withholding the full amount at the time of transfer and the buyer completes and signs Form 593-I, Real Estate Withholding Installment Sale Agreement. These new withholding rules apply only to resident and nonresident individuals. A different regime applies to corporations, partnerships, LLCs treated as partnerships, irrevocable trusts, estates where the decedent was a California resident, and certain other entities. Such entities may be completely exempt from California withholding on the disposition of California real property. See California Form 593-W and Instructions.

Special California withholding provisions apply to Section 1031 exchanges by individuals. If the exchange is simultaneous, the transfer is exempt from withholding but there is still a withholding requirement imposed on any proceeds that the transferor receives from the escrow. If the exchange is deferred, the transfer is exempt from withholding but only at the time of the initial transfer. The Instructions to Form 593-C provide that the sales proceeds must be transferred directly to an intermediary or accommodator, and that the intermediary or accommodator must withhold on any cash or cash equivalent received by the transferor. If the exchange does not take place, or if the exchange does not qualify for nonrecognition treatment (in whole or in part) due to the failure of the transaction to meet the time requirements of Section 1031(a)(3), the transferee (including for this purpose any intermediary or accommodator in a deferred exchange) is required to notify the Franchise Tax Board within 10 days after the expiration of the statutory periods in Section 1031(a)(3) and thereafter remit the applicable withholding amounts to the Franchise Tax Board. These new rules create many questions, compliance burdens and major withholding obligations for QIs that do business in California.

We now discuss several of the topics presented above in more detail, including (1) Wiechens and like-kind real property; (2) Rev. Rul. 2002-83 and related party exchanges; (3) Rev. Proc. 2002-69 and entities wholly owned by a husband and wife as community property;

(4) PLR 200251008 and the receipt of a leasehold interest from a related party in a reverse, build-to-suit exchange; and (5) the five PLRs and proposed revenue procedure concerning LKE Programs. Following our discussion are four diagrams illustrating (1) the facts of Rev. Rul. 2002-83; (2) an alternative to Rev. Rul. 2002-83 involving a separate Section 1031 exchange by the related party; (3) the EAT's acquisition of the new 32-year sublease from a related party in PLR 200251008; and (4) the consummation of the taxpayer's build-to-suit exchange in PLR 200251008. The Program Materials include a complete copy of the new case, IRS rulings and other recent Section 1031 developments.

Like-Kind Real Property

In Wiechens v. United States, the taxpayer exchanged certain water rights for a fee interest in farm land. The taxpayer contended that because the taxpayer's water rights constituted an interest in real property, its exchange of the water rights for farm land qualified as a like-kind exchange. However, the Government countered that, "not every exchange of real property interests meets the section 1031 like-kind requirement." Smalley v. Commissioner, 116 T.C. 450 (2001). The Government further argued that Rev. Rul. 55-749, 1955-2 C.B. 295, discussed the tax consequences of an exchange of water rights for a fee simple interest in land, and clearly advised that water rights of a limited amount or duration were not sufficiently similar under Section 1031 to a fee simple interest in land. The District Court in Arizona held in favor of the Government on cross-motions for summary judgment. The Court was persuaded by the argument that an exchange of limited, non-perpetual water rights for a fee simple interest in land does not satisfy the like-kind requirement of Section 1031.

The taxpayer also contended, however, that even if the taxpayer's water rights were limited to a 50-year duration, the water rights should still be considered of a like kind with the fee interest in the farm land, citing the example of the leasehold interest in Treas. Reg. Section 1.1031(a)-1(c)(2). This example treats the exchange of a leasehold of a fee with 30 years or more to run for a fee interest in real estate as a like-kind exchange. The taxpayer argued that the

taxpayer's water rights, which the Court viewed as limited to a 50-year duration, were equivalent to the leasehold of a fee for 30 years or more.

But the Court agreed with the Government's argument that equating the taxpayer's water rights to a leasehold for 30 years or more was inappropriate in this case. As the Tax Court stated in Koch v. Commissioner, 71 T.C. 54, 65 (1978), application of Section 1031 "requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike." Factors to be considered in this analysis include "the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, [and] the duration [of the interests]." Id. The evidence established that the taxpayer's water rights were narrowly restricted, unlike a fee simple interest in land. In particular, the Court determined that the water rights were not perpetual, as the taxpayer had argued, but rather originated from a 1983 water service subcontract that placed many limitations on the water rights, including a 50-year duration. The rights limited the qualified landowners to 7.67% of the total supply of agricultural water available for delivery from the Central Arizona Project (CAP), provided that the CAP water could only be used for irrigation, and stipulated that during water shortages, all municipal, industrial and Indian uses of the water had priority over non-Indian irrigation uses. Although the Court agreed with the taxpayer that its water rights constituted an interest in real property, the Court found that the water rights were limited in priority, quantity, use and duration. Thus, the water rights were not sufficiently similar to the fee simple interest that the taxpayer acquired in the farm land to qualify as like-kind property.

Wiechens is consistent with prior decisions involving mineral rights limited in duration or amount. In Fleming v. Commissioner, 24 T.C. 818 (1955), nonacq. 1956-1 C.B. 6, aff'd in part and rev'd in part on other grounds 241, F.2d 78 (5th Cir. 1957), rev'd on other grounds 356 U.S. 260 (1958), the Tax Court held that an exchange of overriding royalties from oil and gas leases for ranchland was not an exchange of like-kind property since the overriding royalties in that case were a limited mineral interest that would expire when a definite sum of money was received.

The United States Supreme Court upheld this position, finding that the characteristics of such a royalty right made it a different class of property. In Midfield Oil Co., 39 BTA 1154 (1939), the Board of Tax Appeals ruled that an exchange of an oil payment for an overriding oil and gas royalty reserved from the same lease did not qualify under Section 1031 because the oil payment was limited and would terminate after a specified amount of proceeds had been received and thus was not of like kind to the royalty interest. See also Clemente, Inc. v. Commissioner, T.C. Memo 1985-367 (right to extract gravel down to the adjoining land was not of like kind to a fee interest). On the other hand, perpetual mineral rights are considered to be of like kind to estates in real property. For example, a tenant-in-common interest in oil deposits is of like kind to a fee interest in improved real property. Rev. Rul. 68-331, 1968-1 C.B. 352. An overriding royalty interest in minerals is of like kind to a city lot. Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941). An interest in overriding oil and gas royalties is of like kind to unimproved real property. Rev. Rul. 72-117, 1972-1C.B. 226.

Last year we discussed three private letter rulings that each involved a perpetual conservation easement (PCE) granted with respect to the taxpayer's ranch property. The IRS ruled that a PCE was of like kind to a fee interest in a new ranch. PLR 200201007 (10/2/01), PLR 200203033 (10/18/01), and PLR 200203042 (10/18/01). Under the applicable state law, the purpose of a PCE is to retain land predominantly in its natural, scenic, historical, agricultural, forested or open space condition. A PCE is perpetual in duration and constitutes an interest in real property notwithstanding the fact that it is negative in character. The IRS noted that under the regulations, "the types of real estate interests that are within the same kind or class as fee interests in real estate are broad." For example, a leasehold of a fee with 30 years or more to run may be exchanged for a fee interest. The rulings cited Rev. Rul. 55-749, 1955-2 C.B. 295, and Rev. Rul. 72-549, 1972-2 C.B. 472, which held that perpetual easements in the form of water rights and rights-of-way are of the same kind or class of property to which a fee interest belongs (all being perpetual in nature). See also PLRs 9851039, 9621012, 9601046, 9232030 and 9215049 (each involving a perpetual easement for a fee interest).

The Smalley case (cited above) also involved a like-kind issue. In 1994, the taxpayer transferred 2-year timber cutting rights in his land in exchange for fee interests in three parcels received in 1995. The case was decided under the installment sale rules so that no gain had to be recognized in 1994. The court did not rule on the like-kind issue, but noted that it was “reasonable to believe” that like-kind property would be received since the relinquished and replacement properties were interests in real property. The court’s opinion has a detailed discussion of the authorities on the like-kind issue, including an analysis of Georgia state law as applied to standing timber (and related timber-cutting rights). The opinion notes that not all exchanges of real property interests meet the like-kind requirement, including certain interests in land of limited duration or amount that are exchanged for a fee (e.g., carved-out oil payments, gravel extraction rights, short-term leasehold interests). For treatment as like-kind property, it is a necessary but not a sufficient condition that the interests are characterized as real property under state law. See the cases cited in Smalley, Phillips & Rocca, “Summary of Recent Developments under Section 1031” (15th Annual NRDC Conference) (April 25, 2002) at 99-103, and Phillips & Rocca, “Like-Kind Real Property” (6th Annual NRDC Conference) (April 19, 1993).

RELATED PARTY EXCHANGES

In Rev. Rul. 2002-83, the IRS confirmed that Section 1031(f)(4) applies to a deferred exchange in which a related party receives cash or other non-like-kind property on the sale of the taxpayer’s replacement property. In two prior TAMs, the IRS ruled that Section 1031(f)(4) applied to simultaneous exchanges where the related party received cash on the sale of the replacement property, even though the taxpayer exchanged with a QI and not directly with the related party. TAM 200126007 (6/29/01); TAM 9748006 (11/28/97). These transactions are not “direct exchanges” made between related parties under Section 1031(f)(1) because the taxpayer transfers the relinquished property to, receives the replacement property from, and “exchanges with” an unrelated QI. The related party is simply the cash seller of the replacement property to the QI. But Rev. Rul. 2002-83 reinforces the TAMs and holds that these transactions are covered

by the broad anti-abuse language of Section 1031(f)(4) even if the exchange is a deferred exchange with a QI.

Section 1031(f)(4) provides that the nonrecognition provisions of Section 1031 do not apply to “any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection [the related party rules of Section 1031(f)].” In other words, Section 1031 does not apply at all to such an exchange, and the exchange will generally be taxable under Section 1001 absent nonrecognition treatment under Section 1031. The meaning and scope of this provision is not self-evident. Section 1031(f)(4) is written in general terms and is intended to be all-inclusive. It applies to ANY exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of the related party rules. It would have been helpful if the statute cited some specific examples, such as a related party’s sale of the taxpayer’s replacement property within two years of the taxpayer’s exchange.

To understand Section 1031(f)(4), one has to understand the other provisions of Section 1031(f), the purposes of those provisions, and the underlying legislative history. The legislative history underlying Section 1031(f) states that “if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, ‘cashed out’ of the investment, and the original exchange should not be accorded nonrecognition treatment.” H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989). Thus, the related parties are viewed as one economic group for purposes of Section 1031(f). “Cashing out” of the investment is deemed to occur when a related party sells the taxpayer’s replacement property to a QI and receives the sales proceeds from the QI’s sale of the taxpayer’s relinquished property.

Facts of Rev. Rul. 2002-83. The facts of the Revenue Ruling are illustrated in the diagram that follows this article. Individual A owns real property (Property 1) with a fair market value of \$150x and an adjusted basis of \$50x. Individual B owns real property (Property 2) with a fair market value of \$150x and an adjusted basis of \$150x. Both Property 1 and Property 2 are

held for investment within the meaning of Section 1031(a). A and B are related persons within the meaning of Section 267(b).

C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C and a qualified intermediary (QI). QI is unrelated to A and B.

Pursuant to their agreement, on January 6, 2003, A (the taxpayer) transfers Property 1 to QI and QI transfers Property 1 to C (the unrelated buyer) for \$150x. On January 13, 2003, QI acquires Property 2 from B (the related party), pays B the \$150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A. The transaction is a deferred exchange by A because A transfers the relinquished property (Property 1) on January 6, 2003 and subsequently receives the replacement property (Property 2) on January 13, 2003.

The IRS's Analysis. The IRS began its analysis by discussing the “purposes” of Section 1031(f). The IRS stated that “Section 1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property.” The IRS cited the legislative history underlying Section 1031(f): “if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, ‘cashed out’ of the investment, and the original exchange should not be accorded nonrecognition treatment.” H.R. Rep. No. 247, 101st Sess. 1340 (1989). But one could argue that this language only addresses direct exchanges by related parties, not a situation where the related party simply sells its own property and doesn't “exchange with” the taxpayer.

The IRS then took its analysis the next step and noted that Section 1031(f)(4) foreclosed the loophole presented by transactions that were not direct exchanges between related parties. The IRS stated: “ To prevent related parties from circumventing the rules of §1031(f)(1),

§1031(f)(4) provides that the nonrecognition provisions of §1031 do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the purposes of §1031(f)(1) [the statute, however, says “this subsection,” meaning Section 1031(f)].” The IRS referred to the legislative history underlying Section 1031(f)(4). The legislative history provides the following example:

“If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 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.” Id. at 1341.

This example is not a model of clarity and may be phrased as follows:

“If a related party, pursuant to a prearranged plan, sells high-basis property to an unrelated party (including a QI) who then exchanges the high-basis replacement property with the taxpayer for the taxpayer’s low-basis relinquished property within 2 years of the sale in a transaction otherwise qualifying under Section 1031, the taxpayer will not be entitled to nonrecognition treatment under Section 1031.”

In rephrasing the example, we simply substituted the related party for the taxpayer (and vice versa) because it is customary to label the “taxpayer” as the party undertaking the exchange. The taxpayer’s exchange is what is at issue under Section 1031(f)(4). We also clarified that the related party’s “transfer of property” to the unrelated party is, in the cases presenting the most abuse under Section 1031(f), a sale of high-basis property for cash or other non-like-kind property. This is consistent with the legislative history quoted above. Further, we clarified that the unrelated party (including a QI) exchanges that high-basis property (the taxpayer’s replacement property) for the taxpayer’s low-basis relinquished property. This is again consistent with the legislative history which refers to exchanges of high-basis property for low-basis

property in anticipation of the sale of the low-basis property. Finally, we deleted the word “previous” from the example in the legislative history because it is immaterial whether the related party’s transfer of the high-basis property to the unrelated party is prior to, at the same time as, or subsequent to the taxpayer’s exchange as long as it is “within 2 years.” As we have rephrased it, it is clear that the example in the legislative history precisely describes the situation presented in Rev. Rul. 2002-83 and mandates the application of Section 1031(f)(4) to the taxpayer’s exchange.

After citing the example in the legislative history, the IRS continued its analysis as follows: “Accordingly, under §1031(f)(4), if an unrelated third party is used to circumvent the purposes of the related party rule in §1031(f), the nonrecognition provisions of §1031 do not apply to the transaction. In the present case, A is using QI to circumvent the purposes of §1031(f) in the same way that the unrelated party was used to circumvent the purposes of §1031(f) in the legislative history example. Absent §1031(f)(1), A could have engaged in a like-kind exchange of Property 1 for Property 2 with B, and B could have sold Property 1 to C. Under §1031(f)(1), however, the non-recognition provisions of §1031(a) do not apply to that exchange because A and B are related parties and B sells the replacement property within 2 years of the exchange. . . . [T]he end result of the transaction is the same as if A had exchanged property with B followed by a sale from B to C. This series of transactions allows A [through the related party, B] to effectively cash out of the investment in Property 1 without the recognition of gain. A’s exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of §1031(f) and, under §1031(f)(4), the non-recognition provisions of §1031 do not apply to the exchange between A and QI. A’s exchange of Property 1 for Property 2 is treated as a taxable transaction.”

IRS’s Holding. The IRS held: “**Under the facts described above**, a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under §1031(a) if, as part of the transaction, **the related party receives cash or other non-like-kind property** for the replacement property.” [Emphasis added.]

Those who choose to see the glass as half-full will emphasize the first clause of the IRS's holding: "under the facts described above." Those facts included (1) clear and substantial basis-shifting in the exchange: the related party had a high-basis in the replacement property and realized no gain on the sale, as compared to the taxpayer's low basis in the relinquished property; (2) a prearranged plan for the related party to sell the replacement property to the QI and for the taxpayer to receive that property in the exchange since the taxpayer entered into an agreement for the transfers of the properties with the related party, unrelated buyer and QI prior to the consummation of the exchange; (3) actual completion of the exchange within one week after the transfer of the relinquished property (and thus within the 45-day identification period), with no attempt to acquire other replacement property from an unrelated party; (4) the use of the QI to "circumvent the purposes of §1031(f)" in the same way as the unrelated party in the legislative history example since the taxpayer "could have" engaged in a like-kind exchange of Property 1 for Property 2 with the related party, and the related party "could have" sold Property 1 to the unrelated buyer; and (5) the related party's sale of the replacement property to the QI for cash, thereby receiving all of the sales proceeds from the QI's prior sale of the taxpayer's relinquished property.

Those who see the glass as half-empty will emphasize the last clause of the IRS's holding: "the related party receives cash or other non-like-kind property" for the replacement property. In other words, that fact ("cashing out" of the investment in the two-year period) is determinative and mandates the application of Section 1031(f)(4). The other facts are not controlling, such as the magnitude of the basis-shifting, whether the related party realizes significant gain on the sale, whether the sale of the replacement property to the QI is "prearranged" before the transfer of the relinquished property, whether the taxpayer attempts to acquire replacement property from an unrelated party, whether a direct exchange is possible and whether the QI is used to "circumvent" the purposes of the related party rules. Under this interpretation of the IRS's holding, it does not matter if these other facts are different. If, as part of the transaction, the related party receives

cash or other non-like-kind property for the replacement property, the taxpayer's exchange will be taxable as a result of the application of Section 1031(f)(4).

Impact of Rev. Rul. 2002-83. Many deferred exchanges in which the taxpayer desires to receive replacement property owned by a related party will fit roughly within the facts of Rev. Rul. 2002-83. There will typically be some basis-shifting. Even if the related party realizes some gain on the sale of the replacement property, that gain will usually be much smaller than the taxpayer's gain in the relinquished property. There will typically be some interdependence between the exchange and the related party's sale to the QI. This is true even if the transaction is a deferred exchange and the QI acquires the replacement property from the related party "as a last resort" after attempting to acquiring replacement property from unrelated parties. There is proximity in time since the replacement property must be identified in 45 days and received in 180 days after the transfer of the relinquished property. Further, there is interdependence in the flow of funds since the related party sells the replacement property to the QI and receives the sales proceeds from the QI's sale of the taxpayer's relinquished property. Moreover, the IRS previously ruled in TAM 200126007 that the feasibility of a direct exchange between related parties is irrelevant and not a criterion for the application of Section 1031(f)(4). Following Rev. Rul. 2002-83, nearly all of these transactions in which a related party sells the replacement property for cash are presumptively taxable under Section 1031(f)(4), even if the exchange is a deferred exchange.

Prior to the issuance of Rev. Rul. 2002-83, Weller and Drucker in Real Property Exchanges (3d. Ed. CEB 2002) at p. 128 stated:

"It remains to be seen whether any acquisition of property from a related party following disposition of property in a deferred (not simultaneous) exchange can fall within IRS §1031(f)(2)(C). Some experts have suggested that, when a taxpayer can demonstrate intent to acquire third party property but identifies related party property as a "back-up" to other property in a deferred exchange, it might be possible to acquire the related property if (but presumably only if) the third party property cannot be acquired despite good faith efforts to do so."

See also Long and Foster, Tax-Free Exchanges Under Section 1031 (West Group 2002) at p. 82.

While Rev. Rul. 2002-83 does not specifically address this exact scenario (the taxpayer in the ruling only attempted to acquire the replacement property owned by a related party), the conservative and realistic interpretation of the IRS's holding suggests that such an exchange will be taxable under Section 1031(f)(4) (assuming that there is some basis-shifting and the related party receives cash or other non-like-kind property). Rev. Rul. 2002-83 applies Section 1031(f)(4) to a deferred exchange involving a QI. There is no good reason to believe that the application of Section 1031(f)(4) may be avoided merely because the taxpayer acquires replacement property from a related party as a "last ditch" alternative in a deferred exchange. This conclusion is strongly supported by the IRS's analysis in Rev. Rul. 2002-83 and prior TAMs. The perceived abuse under Section 1031(f) occurs as a result of the related party's receipt of cash or other non-like-kind property ("cashing out" of the investment), irrespective of whether such replacement property is acquired as a first or last resort. We believe that Rev. Rul. 2002-83, together with TAM 200126007 (which applied to a simultaneous exchange), invalidates the above suggestion made by "some experts," assuming that this suggestion had any merit previously.

TAM 200126007 (6/29/01) involved sales of replacement property by a related party in a four-party simultaneous exchange involving the taxpayer, unrelated purchasers and a QI. The taxpayer did not recognize the gain realized on the exchange of the relinquished property. The related party reported the gain on the sale of one replacement property and deferred the loss on the sale of the other replacement property under Section 267(f). The taxpayer and related party, viewed as a group, reduced its investment in real estate. The taxpayer's low-basis residential properties were disposed of in the exchange. If Section 1031 applied to the exchange, the taxpayer's basis would be shifted to the replacement property previously owned by the related party. The sale proceeds of the taxpayer's relinquished property were received by the related party upon its sales of the replacement property and reduced the related party's bank debt.

The IRS determined that the transactions fit squarely within Section 1031(f)(4) by shifting

basis and cashing out investments through an exchange involving related parties. Accordingly, the exchange by the taxpayer was taxable under Section 1031(f)(4). The TAM is consistent with previous rulings applying Section 1031(f)(4) to transactions in which a related party sells the replacement property involved in a taxpayer's exchange. See TAM 9748006 (11/28/97); FSA 199931002 (4/12/99). See also Weller & Phillips "What's New in Like-Kind Exchanges" (NYU 57th Inst. Fed. Taxn. Bender & Co. 1999) (Section 14.03 Related Party Exchanges); Phillips & Rocca "Related Party Exchanges: What Works, What Fails and What Remains Uncertain" (11th Annual NRDC Conference) (April 16, 1998).

The taxpayer made a number of arguments to avoid the application of Section 1031(f)(4), all to no avail. For example, the taxpayer argued that Section 1031(f)(4) is limited to circumstances in which a direct exchange with a related party and subsequent disposition would have been feasible. The taxpayer contended that various business and market imperatives made a direct exchange impractical since it would have created problems for the buyer and for the lender on the replacement property, and may have subjected the taxpayer's shareholders who were on the related party's board of directors to conflict of interest charges. But the IRS responded that Section 1031(f)(4) denies Section 1031 nonrecognition treatment to ANY exchange which is part of a transaction structured to avoid the purposes of Section 1031(f). The exchange need not be a direct exchange with a related party. A position that Section 1031(f)(4) only applies in circumstances where a direct exchange and subsequent sale would have been feasible "would unwarrantedly restrict the application of Section 1031(f)(4) on the basis of circumstances that have little, if any, relationship to the purposes of that Section" and "there is no authority for such a position." Thus, the feasibility of a direct exchange is irrelevant and not a criterion for the application of Section 1031(f)(4).

The taxpayer in TAM 200126007 also argued that Section 1031(f) does not apply to a related party's sale to a QI. The IRS responded: "The purpose of Section 1031(f)(4), as indicated in the legislative history, is to deny nonrecognition treatment to any exchange (other than direct exchanges specifically addressed in Section 1031(f)(2)) that is part of a transaction (or series of

transactions) which involves related parties and is structured to avoid the purposes of Section 1031(f), e.g., denial of nonrecognition treatment for any exchange that is part of a transaction (series of transactions) that involve[s] basis shifting, ‘cashing out’ of an investment, reduction or avoidance of gain, or acceleration of losses.” The IRS further noted that the example in the Senate Finance Committee Report indicates that “reordering the sequence of transactions” will not place the transactions beyond the scope of Section 1031(f)(4). If the application of Section 1031(f) were limited as suggested by the taxpayer, the IRS stated that the provision would be meaningless since its application could be easily circumvented by using an intermediary. But the use of an intermediary to avoid tax on the disposition of a taxpayer’s low-basis property and the intermediary’s application of the sales proceeds to purchase replacement property from a related party facilitates avoidance of the purposes of Section 1031(f). Thus, Section 1031(f)(4) covers situations where there are related party sales rather than exchanges.

Warning. The IRS has consistently ruled that Section 1031(f)(4) applies to sales of replacement property owned by related parties in connection with a taxpayer’s exchange. We are unaware of any reported exception. Rev. Rul. 2002-83 is the first ruling to apply to a deferred exchange and further tightens the noose around the neck of these transactions. Taxpayers have tried all kinds of interesting arguments in TAM 200126007 and TAM 9748006 to avoid the application of Section 1031(f)(4) to such transactions, but all of these arguments have been rejected by the IRS. Will some practitioners continue to assert that an acquisition of replacement property from a related party as a “back-up” in a deferred exchange falls within Section 1031(f)(2)(C) notwithstanding the IRS’s holding in Rev. Rul. 2002-83? Is the glass half-empty or half-full? Despite the logic of the IRS’s position, many taxpayers still want to receive replacement property that is sold by a related party for cash or other non-like-kind property. Some advisors allow them to do so, mistakenly thinking that interposing a QI will avoid Section 1031(f), that the taxpayer has a good business reason, or that the taxpayer’s case is otherwise so exceptional as to avoid Section 1031(f)(4).

Weller and Drucker in Real Property Exchanges, *supra*, at p. 128 caution:

“The safe approach is not to purchase related party property as replacement property in any like-kind exchange . . .involving the following characteristics:

- Before any property dispositions, two related parties each own property;
- At least one of the properties has a fair market value different from its adjusted basis;
- One of the parties (T) undertakes a like-kind exchange in which the other related party’s property is obtained as replacement property;
- The other party (RP)...recognizes a loss, or recognizes a gain that is less than the gain realized by T on its exchange, or recognizes any gain that is offset by virtue of RP’s tax attributes_such as available net operating losses, passive loss carryovers, effective tax rate, available credits_that are not equally available to T.”

To quote Joe Pesci in the movie, “Casino”: “You’ve been warned!”

The Silver Lining. If Rev. Rul. 2002-83 is seen as a dark cloud, it is one with a silver lining. First, the ruling suggests that a transaction without any basis shifting may conceivably fall within Section 1031(f)(2)(C), and thus not be avoidance of the related party rules and subject to Section 1031(f)(4). For example, suppose the related party had a basis of \$50x in Property 2 (an amount equal to the taxpayer’s basis in Property 1) and recognized a gain of \$100x on the sale to the QI (an amount equal to the taxpayer’s gain in Property 1). In such a situation, there is arguably no basis shifting in the exchange. It would be a very harsh result to tax both the related party on its sale and the taxpayer on its exchange when the related parties (viewed as one group) effectively cashed out of only one property (Property 1), not two properties. It may be argued that neither Section 1031(f)(1) nor Section 1031(f)(4) should apply to an exchange in which there is no basis shifting and that Section 1031(f)(2)(C) should exempt such transactions.

The legislative history underlying Section 1031(f) specifically supports this conclusion. The Senate Finance Committee Report states that “transactions that do not involve basis shifting” are intended to qualify for the non-tax-avoidance exception of Section 1031(f)(2)(C), as well as certain exchanges of undivided interests between related parties and “dispositions in nonrecognition transactions.” S. Rpt. No. 101-56 at 152 (1989). See also PLR 199926045 (4/2/99) (ruling that Congress did not intend for Section 1031(f) to apply to a subsequent disposition by a related party in the two-year period following an exchange of undivided interests between related parties based on the Senate Finance Committee Report). Significantly, Rev. Rul. 2002-83 avoids this issue and assumes a clear and substantial case of basis-shifting. The related party in the ruling sells high-basis property compared to the taxpayer’s low-basis relinquished property and realizes no gain on the sale (having a basis equal to the sales price of \$150x).

Second, Rev. Rul. 2002-83 assumes that the related party receives cash or other non-like-kind for the replacement property. In fact, that is the central and determinative component of the IRS’s holding in our view. This suggests that if the related party received like-kind property for the replacement property (rather than cash or other non-like-kind property), the exchange would not have afoul of the related party rules and Section 1031(f)(4) would not have applied. In other words, Rev. Rul. 2002-83 does not apply to a situation where the related party effects its own Section 1031 exchange and receives like-kind property for the replacement property, instead of cash or non-like-kind property. If both parties hold their respective replacement properties for the two-year period, the taxpayer’s exchange should not be taxable under Section 1031(f)(4).

By its own terms, Rev. Rul. 2002-83 is carefully limited to cases where the related party receives cash or other non-like-kind property for the replacement property. The only type of consideration other than cash or non-like-kind property is like-kind property, which is expressly omitted. If the IRS believed that Section 1031(f)(4) would also apply to situations where the related party receives like-kind property for the replacement property, there would be no reason to restrict the holding in this way. The ruling could have simply assumed that the related party transferred the replacement property to the QI for any consideration. Instead, the ruling focuses

on the related party's receipt of cash or other non-like-kind property (i.e., the receipt of the sales proceeds from the QI's sale of the taxpayer's relinquished property). The entirely different situation where the related party receives like-kind property for the replacement property is patently avoided. Perhaps we read too much into the holding of Rev. Rul. 2002-83, but there is nothing in the ruling to suggest that a separate exchange by the related party for like-kind property would have disqualified the taxpayer's exchange. Thus, even those of us who see the glass as half-empty, at least in this respect, also see it as half-full.

Separate Section 1031 Exchange By Related Party. In a diagram at the end of this article, we outline an alternative to the taxable result under Rev. Rul. 2002-83. This alternative involves a separate Section 1031 exchange by the related party. Instead of receiving cash or other non-like-kind property on the sale of the replacement property, the related party exchanges the replacement property for other like-kind property in its own Section 1031 exchange. Both the taxpayer and related party then hold their respective replacement properties for two years after the last transfer involved in the exchange. We argue that such transactions should not violate the related party rules of Section 1031(f) and thus both exchanges should qualify under Section 1031.

Suppose that the taxpayer (T) and the related party (RP) in Rev. Rul. 2002-83 engage in separate Section 1031 exchanges as follows. Exchange By T: T exchanges Property 1 for Property 2 with QI₁. T transfers Property 1 to QI₁. QI₁ sells Property 1 to C (an unrelated buyer), purchases Property 2 from QI₂, and transfers Property 2 to T to complete T's exchange. Exchange by RP: RP exchanges Property 2 for Property 3 with QI₂. RP transfers Property 2 to QI₂. QI₂ sells Property 2 to QI₁, purchases Property 3 (which is like-kind property) from S (an unrelated seller) using the sales proceeds, and transfers Property 3 to RP to complete RPs exchange. Arguably, there is no abuse under Section 1031(f) because neither T nor RP cashes out of its investment; they merely receive like-kind property in separate exchanges.

If the transaction is recharacterized as a direct exchange between T and RP, the same

result follows. Suppose that T exchanges Property 1 for Property 2 with RP in a direct exchange subject to Section 1031(f)(1). Subsequently, RP exchanges Property 1 for Property 3 in a like-kind exchange. These transactions have the same end result as the separate exchanges with the QIs described above. Neither party cashes out in the transactions. RP's subsequent disposition of Property 1 for Property 3 in the two-year period should be exempt under Section 1031(f)(2)(C) because it is a "disposition in a nonrecognition transaction" (i.e., a separate Section 1031 exchange by RP). The Senate Finance Committee Report (cited above) states that Congress did not intend for Section 1031(f) to apply to a subsequent disposition that is a nonrecognition transaction.

This legislative history was respected in PLR 199926045 (4/2/99). This ruling involved a partition exchange of undivided interests in timberland between related parties, followed by a disposition (the cutting and sale of timber) in the two-year period. The IRS cited the legislative history and concluded that "Congress did not intend for this subsection [Section 1031(f)] to apply to a subsequent disposition under these circumstances." Accordingly, the IRS ruled that any subsequent disposition by the related party of its interests in the timberland received in the exchange would not trigger recognition of gain under Section 1031(f)(1). Based solely on the legislative history, the disposition was assumed not to have tax avoidance as one of its principal purposes and was considered exempt under Section 1031(f)(2)(C). The use of the non-tax-avoidance exception of Section 1031(f)(2)(C) requires an explanation to be attached to Form 8824 in the case of a direct exchange between related parties. Further, the exception must be "established to the satisfaction of the Secretary," and depends on the facts and circumstances of each case. But to the extent that a private letter ruling may constitute "authority," PLR 199926045 is authority that the IRS will respect the three situations that Congress intended to qualify for the non-tax-avoidance exception of Section 1031(f)(2)(C). One of the three situations is "dispositions in nonrecognition transactions," and a Section 1031 exchange is one type of disposition in a nonrecognition transaction.

Thus, a separate Section 1031 exchange by a related party should avoid a taxable result

under Section 1031(f) and Rev. Rul. 2002-83. It should not matter whether the related party has a high or low basis, defers any significant gain, or would have otherwise done a Section 1031 exchange. This is immaterial in a direct exchange under Section 1031(f)(1) and should likewise be irrelevant under Section 1031(f)(4). Basis shifting is permissible under Section 1031(f) as long as the related parties do not cash out in the transactions and hold their respective replacement properties for the two-year period. If the related party does a Section 1031 exchange, and holds the replacement property for two years, both parties continue their investment in like-kind property, and there is no actual abuse under Section 1031(f).

It is unclear whether a taxpayer may obtain a PLR for the taxpayer's exchange if the related party effects its own Section 1031 exchange (including the transaction described above and in the diagram). In PLR 9126007 (6/28/91), the IRS declined to rule under Section 1031(f)(2)(C) on an anticipated second disposition by the related party where that disposition was a recognition transaction and there was basis shifting. The IRS stated: "We also decline to make any determination concerning the tax effect which the subsequent dispositions anticipated will have on the exchange. Whenever a disposition, which is subsequent to an exchange, is a recognition transaction or the exchange itself involves shifting of basis between properties, no ruling will be issued on whether the exchange will continue to be afforded nonrecognition treatment under section 1031(f)(2)(C) of the Code. (In this case, both circumstances will exist.)...[W]e think it appropriate and consistent for the Service to administratively decline to rule on the issue of whether gain recognition will be triggered upon the second disposition....It would be better policy to leave it to an examining agent to ascertain whether one of the taxpayer's principal purposes for engaging in this series of transactions is the avoidance of Federal income tax." Does PLR 199926045 supersede PLR 9126007 with respect to the IRS's view of a ruling request under Section 1031(f)(2)(C)? The two PLRs may be reconciled on the ground that the second disposition in PLR 9126007 was not mentioned as an exception to Section 1031(f) in the legislative history, while the second disposition in PLR 199926045 was specifically cited as meeting the non-tax-avoidance exception. A "disposition in a nonrecognition transaction" is also expressly cited as an exception in the legislative history, and a Section 1031 exchange by the

related party is unlike the taxable second disposition in PLR 9126007. Thus, it may be possible to obtain a ruling on this issue following PLR 199926045, although we are unaware of any such requests currently before the IRS.

Advantages of Separate Exchange. The main advantage of a separate exchange by the related party is that the taxpayer should avoid having to recognize its of gain under Section 1031(f). The taxpayer still disposes of the relinquished property and still acquires the replacement property owned by the related party. The related party simply cannot receive cash or other non-like-kind property but must receive like-kind property in its own Section 1031 exchange. This allows taxpayers to receive replacement property owned by a related party where, for various business or other reasons, the taxpayer must or desires to acquire such property. In addition, the taxpayer can identify and be assured of receiving such replacement property as a last resort. Viewing the related parties as one economic group, they dispose of the low-basis relinquished property without recognizing gain and end up with new like-kind property to be owned by the related party (instead of the taxpayer).

If the related party's exchange is a deferred exchange, the related parties will have additional time to acquire the related party's replacement property. The taxpayer's exchange will be completed when it receives the related party's property. The related party will then have its own 45-day and 180-day periods to acquire its replacement property. It is unclear how far the 45-day and 180-day time limits may be stretched through multiple deferred exchanges by related parties. It is also unclear how the two-year holding period of Section 1031(f) would be measured. Arguably, the two-year holding period begins to run only after the last property is received in the last exchange since avoidance of Section 1031(f)(4) and nonrecognition treatment for each exchange depends on each subsequent exchange. If the last exchange fails, there would be a domino effect. Each preceding exchange would likely be taxable under Section 1031(f)(4), including the original exchange by the taxpayer. Ultimately, a related party must acquire like-kind property from an unrelated party to avoid cash or other non-like-kind property going to a related party. Only if there were more than six consecutive deferred exchanges by related parties

(each of which must be completed in 180 days) would a potential three-year statute of limitations issue arise for the original exchange by the taxpayer. Related parties should avoid more than one deferred exchange by a related party following the taxpayer's exchange. These transactions may be controversial enough for the IRS without creating additional issues arising out of a potentially endless chain of deferred exchanges by related parties.

A separate Section 1031 exchange by a related party (as shown in the diagram) is an alternative to the taxable result under Rev. Rul. 2002-83. While no case or ruling specifically holds that such a transaction avoids Section 1031(f)(4), a very strong argument can be made that this transaction does not avoid the purposes of the related party rules. This assumes that neither party cashes out and both parties hold their replacement properties for two years after the last transfer that is part of either exchange. When the two-year holding period expires, the related party may sell its high-basis property just as it can do after a direct exchange under Section 1031(f)(1). FSA 200137003 (9/14/01) confirmed that a sale more than two years after a like-kind exchange between related parties will not trigger gain recognition, either under Section 1031(f)(1) (which applies only to dispositions in the two-year period after a direct exchange) or under Section 1031(f)(4) (which does not expressly contain a time limitation). The FSA reached this conclusion even though the related parties systematically liquidated adjacent properties and intended to dispose of the replacement property after the two-year period.

HUSBAND AND WIFE PARTNERSHIPS AND LLCS

Rev. Proc. 2002-69, 2002-45 I.R.B. 831, provides for elective classification of "qualified entities" (partnerships and LLCs but not corporations) solely owned by a husband and wife as community property. The IRS issued Rev. Proc. 2002-69 because taxpayers were unsure of the classification for an entity that is owned solely by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States. To alleviate this uncertainty and in the interest of administrative simplicity, the revenue procedure provides that the IRS will respect a taxpayer's treatment of these entities as either disregarded entities or

partnerships. A business entity is a qualified entity if: (1) the business entity is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States; (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) the business entity is not treated as a corporation under Treas. Reg. Section 301.7701-2.

If a qualified entity and the husband and wife as community property owners treat the entity as a disregarded entity for federal tax purposes, the IRS will accept the position that the entity is a disregarded entity for federal tax purposes. If a qualified entity and the husband and wife as community property owners treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the IRS will accept the position that the entity is a partnership for federal tax purposes. A change in reporting position will be treated for federal tax purposes as a conversion of the entity. The Revenue Procedure is effective on November 4, 2002.

Background. Prior to Rev. Proc. 2002-69, it was unclear whether a qualified entity solely owned by a husband and wife as community property should be treated as owned by “two or more members” (creating a partnership) or by a “single owner” (creating a disregarded entity) under Treas. Reg. Section 301.7701-3(b)(1). In general, a husband and wife are each considered a separate “person” and “taxpayer” under the Code. See Sections 7701(a)(1) and (14); PLR 8429004 (wife had to report 50% of the gain on involuntarily converted property owned by a husband and wife as tenants in the entirety when only husband received title to replacement property under Section 1033). The above regulations referred to a “single owner” as the basis for disregarding a qualified entity but did not define this term or consider whether community property ownership was equivalent to ownership by a “single owner.” Prior to Rev. Proc. 2002-69, Weller and Drucker in Real Property Exchanges, *supra* at p. 80 stated: “Although there is no direct authority, many tax practitioners believe that spouses (regardless of whether they hold property as joint tenants or tenants-in-common or as community property) cannot both be members of the same LLC if they wish to claim that the LLC has only one member. Because each is a separate taxpayer, the IRS will probably view a two-member LLC (even if the two

members are married) as a separate taxpayer [entity] for all purposes.” See also Long and Foster, Tax-Free Exchanges Under §1031 (West Group 2002) at p. 46.12.

Several cases have held that a husband and wife may create a partnership for federal tax purposes. See, e.g., United States v. Neel, 1995 TNT 38-264 (10th Cir. 1956) (husband and wife formed tax partnership even though they had no formal agreement, partnership books or partnership accounts and did not file partnership returns). The court in Neel cited the Supreme Court’s decision in Commissioner v. Tower, 327 U.S. 280, 290 (1946) which stated: “There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes.” In Gilbreath v. Commissioner, T.C. Memo 1989-445, spouses that operated a cocaine distribution business created a tax partnership, and the wife was liable for self-employment tax on her distributive share of partnership income. The court cited Commissioner v. Tower, *supra*, which held that where a wife contributes to the control and management of the family business, or performs “vital additional services,” she may be a partner. See also Estate of Winkler v. Commissioner, T.C. Memo 1997-4 (wife purchased winning lotto ticket on behalf of deemed family partnership, including her husband and five children).

Some Section 1031 exchanges were affected by this uncertainty over whether a husband and wife could form a single-member LLC and be treated as a disregarded entity. Simple exchanges of relinquished property by a husband and wife became unduly costly and complicated when the lender for the replacement property required a single-asset bankruptcy remote entity. If only one entity was created that was owned by a husband and wife, the entity would likely be treated as a partnership since it had two members, and the exchange could be disqualified. The same taxpayer that began the exchange (the husband and wife as individuals) would not complete the exchange (a partnership would receive the replacement property). See Chase v. Commissioner, 92 T.C. 869 (1989); Demirjian v. Commissioner, 54 T.C. 1691 (1970), *affd* 457 F.2d 1 (3d. Cir. 1972); Estate of Aaron Levine v. Commissioner, 72 T.C. 780 (1979); TAM 9818003; TAM 9227002. Further, a husband and wife cannot not receive an interest in a partnership as replacement property under Section 1031(a)(2)(D).

If permitted by the lender, each spouse would typically form his or her own single-member LLC to meet the lender's single-asset entity requirements (one LLC solely owned by the husband and one LLC solely owned by the wife). Each LLC would be treated as a disregarded entity for federal tax purposes, and the two LLCs would own the replacement property as tenant-in-common co-owners (not as a partnership). The spouses would then continue to report direct ownership of the replacement property on their individual or joint tax returns. The IRS has approved exchanges in which title is taken to replacement property in a single-member LLC or other disregarded entity to meet a lender's requirements, to obtain personal liability protection and to avoid transfer tax. See, e.g., PLRs 20013014, 200118023, 9807013 and 9751012. The IRS has also treated a two-member LLC as a disregarded entity where it was owned by single owner and the second member had only limited rights concerning bankruptcy. PLR 9911033.

Impact of Rev. Proc. 2002-69. Under Rev. Proc. 2002-69, a husband and wife who solely own a qualified entity as community property do not need to form two single-member LLCs to meet a lender's single-asset entity requirements. They may form a two-member partnership or LLC and elect to be treated as a disregarded entity. This avoids issues with the lender, such as whether co-ownership by two LLCs is permissible, and additional costs and complications in having to form two entities. Care must be taken by tax return preparers not to file a partnership return for the two-member partnership or LLC since that entity must be treated as a disregarded entity for purposes of Section 1031. Filing a partnership return is treated as electing classification as a partnership under Rev. Proc. 2002-69. Thus, filing a partnership return to report the replacement property could jeopardize a Section 1031 exchange begun by a husband and wife who transfer relinquished property as individuals.

The revenue procedure only applies where the qualified entity is wholly owned by a husband and wife as community property and there is no ownership by another person. However, if a husband and wife acquire the interest of another member or partner so that they solely own a qualified entity as community property after the acquisition, the holdings of Rev. Rul. 99-6, 1999-

1 C.B. 432, should apply. Unless the husband and wife continue to file partnership returns, the partnership will terminate when the spouses acquire the other partnership interest. Under Rev. Rul. 99-6, the selling partner simply treats the transaction as a taxable sale or exchange of a partnership interest under Section 741. But the acquisition is treated differently for purposes of determining the purchasing partner's tax treatment. To determine the purchasing partner's tax treatment, the partnership is deemed to make a liquidating distribution of all of its assets to the partners, and following the distribution the purchasing partner is treated as acquiring the assets deemed to have been distributed to the selling partner in liquidation of his partnership interest.

As a result of Rev. Proc. 2002-69, this same analysis should apply to spouses who own their interests as community property and who elect to treat the partnership as a disregarded entity and cease filing partnership returns. Such spouses should be treated the same as the sole remaining purchasing partner in Rev. Rul. 99-6. They presumably could acquire the partnership interest of the other partner in a Section 1031 exchange, notwithstanding Section 1031(a)(2)(D). This is because of the deemed tax treatment of the transaction as an acquisition of assets (not a partnership interest) following a liquidation of the partnership under Rev. Rul. 99-6.

Rev. Proc. 2002-69 only addresses qualified entities solely owned by a husband and wife as community property under the laws of a state, foreign country or possession of the United States. The revenue procedure does not apply to qualified entities owned by spouses in separate property states or who otherwise own their interests in the entity as separate property. These spouses should continue to form two single-member LLCs (or perhaps a Delaware Series LLC if it is treated as having the same effect) in order to meet a lender's single-asset entity requirements and avoid partnership classification for purposes of Section 1031. Further, upon a divorce, death or other conversion of community property to separate property, the revenue procedure presumably becomes inapplicable. Such events may cause a conversion of the entity from a disregarded entity to a partnership. See, e.g., Rev. Rul. 99-5, 1999-1 C.B. 434 (conversion of single-member LLC to partnership upon admission of second member); Treas. Reg. Section 1.7703-1 (determination of marital status).

PLR 200251008

NEW LEASEHOLD INTEREST FROM RELATED PARTY
REVERSE BUILD-TO-SUIT EXCHANGE

In the introduction, we discussed the rulings made in PLR 200251008. The IRS principally addressed the qualification of the exchange under the administrative safe harbor of Rev. Proc. 2000-37 (the “parking” of the replacement property with the EAT where the replacement property consisted of a new 32-year sublease and improvements made by the EAT). The IRS also addressed the safe harbor for a QI which was applicable to the simultaneous exchange using the “exchange last” method. Finally, the IRS examined the issues presented by construction of the improvements within the 180-day period of Rev. Proc. 2000-37, including any failure to complete improvements before the EAT’s transfer of the replacement property and potential boot. These rulings, in and of themselves, were straightforward. What is most interesting about PLR 200251008, however, is the newly-created 32-year sublease from a related party. Without that lease, the taxpayer’s exchange would not have qualified under Section 1031.

Facts of PLR 200251008. An S corporation (“Taxpayer”) operated a business on the relinquished property (RQ). Taxpayer owned a fee interest in RQ and all improvements thereon. CorpW was an S corporation that was related to Taxpayer. CorpW leased as lessee A-Acres situated on unimproved real property under a Lease and Development Agreement (“Lease”) with a City as lessor. The Lease’s term was 45 years and had one 15-year renewal option. LLC-W, a limited liability company, was related to CorpW and Taxpayer. LLC-W subleased A-Acres from CorpW and all rights, title, interest and obligations under the Lease for the entire term of the Lease. LLC-W planned to utilize A-Acres, in part, as the new location for Taxpayer’s business on RQ. LLC-W was developing and constructing the infrastructure required so that the business could be moved to A-Acres. Taxpayer and CorpW were each owned half and half by Husband’s Trust and Wife’s Trust, respectively. LLC-W was owned 45%, 45% and 10%, respectively, by Husband’s Trust, Wife’s Trust and a minority member.

Buyer and Taxpayer entered into an Option Agreement for Sale and Purchase of RQ (Sale Agreement). Under the Sale Agreement, the Taxpayer agreed to sell RQ to the Buyer for \$B. However, Taxpayer arranged to have the transfer of RQ to Buyer structured as a like-kind exchange under Section 1031. To facilitate a future exchange, Taxpayer used the qualified exchange accommodation arrangement (QEAA) safe harbor provided in Rev. Proc. 2000-37, 2000-40 I.R.B. 308, with an exchange accommodation titleholder (EAT). The EAT acted through a single-member LLC, Titleholder. Taxpayer also used the qualified intermediary safe harbor rules by entering into an exchange agreement with a qualified intermediary (QI). EAT and QI were both limited liability companies, wholly owned by Holding Company, a limited partnership. Holding Company, QI, EAT and Titleholder were unrelated to Taxpayer and not disqualified persons. Initially, the QEAA was between Taxpayer and EAT. Later, Taxpayer's rights under the QEAA were assigned to QI to facilitate transfer of the replacement property (RP) from EAT to Taxpayer. Titleholder was created to enter into the sublease and take title to RP. Titleholder was a limited liability company, with EAT as its sole member, and disregarded for federal income tax purposes.

The exchange occurred as follows: LLC-W subleased C-Acres (which is part of A-Acres), at a market rental rate, for a fixed term of 32 years to Titleholder as part of the QEAA. EAT caused Titleholder to construct RP improvements on C-Acres. Taxpayer identified RQ within 45 days of Titleholder entering into the sublease as provided in Rev. Proc. 2000-37, in a manner consistent with Treas. Reg. Section 1.1031(k)-1(c). Under the QEAA, Titleholder entered into a contract with LLC-W (who acted as Construction Manager and contracted on behalf of Titleholder with independent subcontractors) to construct improvements based on Taxpayer's plans and specifications. In addition, Titleholder used the Bank Construction Loan (described below) to finance the construction of RP improvements by executing a note payable to Taxpayer, thereby obligating itself to pay Taxpayer for draw requests paid to Construction Manager. The cost to construct RP improvements was approximately \$B. The Bank Construction Loan, in the amount of \$E, was funded by Bank, with Taxpayer as maker and

primary obligor. LLC-W and Corps, together with Husband and Wife, were guarantors of the Bank Construction Loan.

Subsequent to the commencement of the construction, Taxpayer assigned its rights under the Sale Agreement for RQ to QI and gave written notice of such assignment to all parties as provided in Treas. Reg. Section 1.1031(k)-1(g)(4)(v). Taxpayer then transferred RQ to Buyer, as provided in the exchange agreement with QI. Taxpayer retained liability on the underlying full recourse mortgage on RQ of approximately \$D by agreement with Bank. RQ was then transferred by QI to Buyer free and clear. Buyer paid the purchase price for RQ to QI and QI received and held in escrow the proceeds from the sale of RQ. RQ constituted substantially all of Taxpayer's assets. Buyer did not assume any liabilities of Taxpayer incident to the purchase.

To complete the exchange, Taxpayer assigned its rights to receive RP under the QEAA to QI. Thereupon, QI directed that EAT transfer RP directly to Taxpayer. EAT effected this transfer by transferring all of its ownership interest in Titleholder directly to Taxpayer. Through this series of transactions, QI purchased RP from EAT using all of the proceeds from the sale of RQ. EAT (through Titleholder) used all of the proceeds from the sale of RQ to pay Construction Manager for construction and services and to pay the loan from Taxpayer in full. Taxpayer used the repayment proceeds to fully pay the Bank Construction Loan before EAT transferred Titleholder to Taxpayer.

In addition to entering into the QEAA, Taxpayer entered into a written exchange agreement with QI. The exchange agreement required QI to acquire RQ from Taxpayer and transfer RQ to a purchaser, and to acquire RP and transfer RP to Taxpayer. Pursuant to the exchange agreement, and as provided in Treas. Reg. Section 1.1031(k)-1(g)(4)(iv) and (v), Taxpayer assigned its rights under the Sale Agreement to sell RQ to QI, assigned its rights under the QEAA to receive RP to QI, and gave written and timely notice of these assignments. Pursuant to these agreements, RQ was transferred, through QI, to Buyer, and Taxpayer received, through QI, complete ownership of RP by the transfer of all ownership interest in Titleholder. The

exchange agreement between Taxpayer and QI also specified that Taxpayer had no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property (in particular the proceeds resulting from the sale of RQ to Buyer) held by QI except as provided in Treas. Reg. Section 1.1031(k)-1(g)(6). Since Taxpayer transferred RQ and received RP simultaneously, the transaction effectively satisfied the time requirements in Section 1031(a)(3). Also, RP did not remain in the QEAA for a period exceeding 180 days.

The entire transaction at issue can be summarized in the following steps: (1) Taxpayer enters into the QEAA with EAT, and enters into an exchange agreement with QI as described. (2) LLC-W subleases RP at a fair market rental for 32 years, to Titleholder, a disregarded entity wholly owned by EAT, as part of a QEAA as defined in Rev. Proc. 2000-37. (3) Taxpayer lends to Titleholder the funds which Taxpayer borrows from Husband's Trust, Wife's Trust and Bank to construct improvements on leased property for the relocation of Taxpayer's business. (4) Taxpayer assigns its rights under the Sale Agreement to QI and gives required notices of such assignment to all interested parties. (5) Taxpayer transfers RQ free and clear through QI to Buyer and QI receives the sales proceeds. (6) Taxpayer assigns its position in the QEAA to QI and gives required notices of such assignment to all interested parties. (7) QI uses the sales proceeds from RQ to pay EAT for all of its ownership interest in Titleholder (which holds all of RP, consisting of the 32-year sublease and newly constructed improvements to suit Taxpayer's business requirements). (8) EAT uses the proceeds received from QI to pay Construction Manager and to pay the loan from Taxpayer in full (which Taxpayer, in turn, uses to pay the Bank Construction Loan in full). (9) QI directs EAT to transfer its membership interest in Titleholder (which holds RP) directly to Taxpayer.

IRS's Analysis. The IRS made the following comments and rulings. First, the IRS described the proposed transaction as "a parking transaction between related parties" (Taxpayer and LLC-W). The IRS ruled that the QEAA safe harbor provided by Rev. Proc. 2000-37 applies to the proposed transaction. Taxpayer also used the qualified intermediary safe harbor as set forth in the deferred exchange regulations, although the exchange itself is expected to be

simultaneous. Qualified indicia of ownership of RP will be held by EAT in compliance with all requirements stated in section 4.02(1) of Rev. Proc. 2000-37. It is and will be Taxpayer's bona fide intent, now and at the time the qualified indicia of ownership of RP is transferred to EAT, that the property held by EAT represent replacement property in an exchange qualifying for nonrecognition of gain (in whole or in part) under Section 1031, consistent with section 4.02(2) of Rev. Proc. 2000-37. Within five days after the transfer of RP to EAT, Taxpayer will enter into the QEAA with EAT providing that EAT (through Titleholder) will acquire RP as required by section 4.02(3) of Rev. Proc. 2000-37. Taxpayer represents that EAT will not be a disqualified person as defined by Treas. Reg. Section 1.1031(k)-1(k). In addition, Taxpayer will enter into an exchange agreement with QI to facilitate the exchange transaction as permitted by Section 1.1031(k)-1(g)(4). Under this provision, QI is not considered the agent of the taxpayer for purposes of Section 1031(a). Thus, Taxpayer's transfer of relinquished property through QI and the subsequent receipt or deemed receipt of like-kind replacement property through QI is treated as an exchange.

The IRS further found that all timing requirements necessary for property to be held in the QEAA will be satisfied. Within 45 days after the transfer of RP to EAT, Taxpayer will identify RQ as required by Section 4.02(4) of Rev. Proc. 2000-37. Also, as required by Section 4.02(5) of Rev. Proc. 2000-37, no later than 180 days after the transfer of qualified indicia of ownership of RP to EAT, RP will be transferred to Taxpayer. Consistent with Section 4.02(6) of Rev. Proc. 2000-37, the total time that EAT will hold RP will not exceed 180 days. RP will be received by Taxpayer simultaneously with its transfer of RQ through QI to Buyer, and the exchange will occur no later than 180 days after the date on which RP is transferred to EAT under the QEAA.

The IRS noted that LLC-W is subleasing C-acres of the unimproved land to Titleholder. EAT and Titleholder will construct improvements on such property by one or more contractors hired and supervised by LLC-W. C-Acres (which is subleased from Corps through LLC-W) together with such improvements, constructed by and for Titleholder, will constitute RP. Once EAT (and Titleholder through LLC-W) completes construction of improvements and the

exchange of RP for RQ is completed, Taxpayer will take ownership of Titleholder (the disregarded entity holding title to RP).

The IRS stated that Taxpayer is exchanging a fee interest in improved real estate for a long-term lease of land for a period of 30 or more years and improvements, and that such properties are of like kind under Treas. Reg. Section 1.1031(a)-1(c)(2). The IRS also cited the legal or contractual arrangements that are permissible under Section 4.03 of Rev. Proc. 2000-37, regardless of whether such arrangements contain arm's length terms. The relevant arrangements in this case included: (1) the fact that EAT and QI are related persons; (2) Taxpayer or a disqualified person guarantees some or all of the obligations of EAT and indemnifies EAT; (3) Taxpayer or a disqualified person loans funds to EAT or guarantees a loan to EAT; and (4) Taxpayer or a disqualified person manages RP, supervises improvement of RP, acts as a contractor, or otherwise provides services to EAT. Footnote 2 of the ruling also noted that the courts have permitted taxpayers great latitude in structuring build-to-suit exchanges and cited many of the key cases. But the IRS did not specifically mention Boise Cascade Corp. v. Commissioner, 33 T.C.M. 1443 (1974), in which the replacement property was previously owned by a related party, sold to an unrelated buyer, leased back to the related party with an option to repurchase it, and improved by the unrelated buyer in anticipation of the exchange. The facts in Boise Cascade Corp. were similar to the facts of the ruling, except that the related party in PLR 200251008 leased (instead of sold) the land upon which the improvements were made.

The IRS pointed out that Treas. Reg. Section 1.1031(k)-1(e) provides that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under Section 1031 merely because replacement property is not in existence or is being produced at the time the property is identified as replacement property. That regulation also requires that a taxpayer identify such property by providing a legal description of the underlying land and as much detail as is practicable regarding the construction of the improvements. In the present case, however, the IRS concluded that "the question of sufficiency of identification of replacement property does not arise because the exchange will be simultaneous, except to the

extent the improvements to C-Acres are incomplete when RP is transferred to Taxpayer.”

If the production of RP is not completed by EAT on or before the date required to satisfy the 180-day requirement of Rev. Proc. 2000-37, EAT will be required by contract to transfer RP to Taxpayer to satisfy that requirement, prior to completion. If this occurs, the identification requirement will be satisfied because Taxpayer will receive RP simultaneously with its transfer of RP.

Finally, the IRS stated that Taxpayer will receive no money or other property directly or indirectly prior to or during the exchange and will receive no economic benefit of money or property other than the replacement property received in the exchange. The only possible exception will be if money or other property is transferred to Taxpayer incident to the failure of the contractors to timely complete improvements on RP prior to the transfer of Titleholder to Taxpayer. In that event, Taxpayer will have taxable boot in addition to its like-kind replacement property.

In a footnote, the IRS cited Section 1031(f)(1) and stated that “both Taxpayer and the related parties continue to be invested in the exchange properties, and are not otherwise cashing out their interest.” The IRS concluded that “§1031(f)(1) is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that was part of the exchange.” This conclusion may assume that granting a new lease under these circumstances (e.g., at a market rental rate with no prepaid rent or capital value) is not a sale, exchange or other “disposition” of property by the related party. See, e.g., Pembroke and Crooks, *infra*. But if that is the case, as it should be, there is no direct or indirect exchange of property between related parties, and Section 1031(f)(1) should not apply to any subsequent disposition by Taxpayer or the related parties of their leasehold interests in the two-year period. Moreover, Section 1031(f)(4) (which is not mentioned by the IRS) should not apply since the sublease does not appear to be structured to avoid the purposes of Section 1031(f) (although there are clearly other tax reasons for granting such a

lease). An entirely different situation would be presented if the related party transferred a leasehold interest with capital value for cash or other non-like-kind property. See Rev. Rul. 2002-83 and above discussion of related party exchanges.

IRS's Holding. The IRS ruled that (1) Taxpayer's exchange will conform with the requirements of the QI and the QEAA safe harbor rules, so that QI and EAT will not be agents of Taxpayer and Taxpayer will not be in actual or constructive receipt of money or other property before receiving RP; and (2) Taxpayer will not recognize any gain upon the transfer of RQ to Buyer and the receipt of RP, except that if planned improvements are not completed within the exchange period, gain will be recognized to the extent of any boot received in the exchange.

Implicit in the IRS's holding is recognition of and respect for the newly-created 32-year sublease from the related party. The IRS assumed that this sublease was bona fide since it provided for market rent. The IRS did not raise any issues other than the Section 1031(f)(1) issue (and that was a concern for the IRS only if there was a subsequent disposition by the taxpayer or related parties of their respective leasehold interests in the two-year period). The IRS simply concluded that since the sublease was for a term of 30 or more years, the sublease and improvements were of like kind to the fee interest in the relinquished property.

The IRS did not express any concern that the transaction was, in essence, a non-like-kind exchange of land for construction services and improvements following the principles of Bloomington Coca-Cola Bottling Co., *infra*. While the taxpayer in Bloomington Coca-Cola Bottling Co. already owned the land upon which the improvements were constructed, in PLR 200251008 the land was already leased to related parties. A new sublease for a term of 32 years was arguably granted by the related party for tax reasons in order for the taxpayer to meet the like-kind test for a leasehold interest of 30 or more years. Further, the taxpayer, through its shareholders, owned and controlled the related parties. Except for a 10% minority interest in LLC-W, all of the entities were part of one economic unit.

PLR 200251008 indicates that it is permissible to exchange for improvements on land already owned by or leased to a related party simply by granting a lease or sublease with a term of 30 or more years to an EAT or a QI. But if that is permissible, it may be argued that it should be equally permissible to exchange for improvements on land already owned by or leased to the taxpayer simply by granting a new lease or sublease of 30 or more years to an EAT or a QI. The economic substance of the transactions is the same (assuming that the taxpayer and related party are viewed as one economic unit). Even if the latter lease is transitory and merges with the fee when the taxpayer receives the replacement property in the second situation, a merger could be easily avoided by interposing a lease by the taxpayer to a related party (including an entity that is disregarded for tax purposes but recognized for legal purposes) and then having the related party sublease to the EAT or QI. The end result of the two situations is essentially the same (disregarding the payment of rent from one pocket to another). And if it is permissible to exchange for improvements on land already owned by the taxpayer simply by granting a new lease or sublease of 30 or more years, why shouldn't the taxpayer be able to exchange land for improvements on land already owned by the taxpayer without such a lease (notwithstanding the holding in Bloomington Coca-Cola Bottling Co.)? Why shouldn't the taxpayer be able to do directly what the taxpayer can do indirectly through leases or subleases under PLR 200251008 and arguably under the second situation described above?

Thus, the IRS could have attempted to disregard the new sublease for purposes of Section 1031 by applying the judicial doctrine of substance over form in order to avoid circumvention of the holding in Bloomington Coca-Cola Bottling Co. A court could uphold such a position. A court could find that the substance of the transaction described in PLR 200251008 is a non-like-kind exchange of land for construction services and improvements on land already owned by the taxpayer through the related party. Similarly, a court could conclude that to respect a new lease or sublease of 30 or more years under these circumstances would be to elevate form over substance. A court could also apply other judicial doctrines, such as business purpose and the step-transaction doctrine, in appropriate cases to disregard a new lease or sublease.

There is no authority, however, that expressly invalidates the transaction in PLR 200251008 or even the second situation described above (improvements on land already owned by the taxpayer where the taxpayer grants a lease or sublease of 30 or more years). As a technical matter, and in form, such transactions comply with the like-kind test for an exchange of a fee for a leasehold as long as the leasehold has 30 or more years to run. See PLR 8304022 (10/22/82) discussed below. Moreover, the taxpayer in PLR 200251008 could contend that the sublease was not entered into solely to avoid federal income tax, but had a business purpose, was made at a market rental rent and was comparable to leases that would be entered into by third parties dealing at arm's length. Given the nature and extent of the leasehold improvements, a third-party lessee would reasonably require a long-term leasehold interest.

The taxpayer in PLR 200251008 could point to Boise Cascade Corp. v. Commissioner, 33 T.C.M. 1443 (1974), as comparable authority to support its tax treatment of the transaction. In that case the court held that land and improvements qualified as like-kind property under Section 1031, even though a related party (parent corporation) sold the replacement property land to an unrelated buyer, leased back the land for 15 years with an option to repurchase it at the same price, supervised construction and was responsible for cost overruns, and arranged for the improvements to the land while title was held by the unrelated buyer. The court found that title to the land did in fact vest in the unrelated buyer while the improvements were constructed (similar to the qualified indicia of ownership acquired by the EAT in the sublease in PLR 200251008). The fact that the unrelated party granted a lease and an option to repurchase affected only the "grade or quality" of the property and did not make it different in kind or class. The court also held that the substance of the transaction was consistent with the form, and that planning and arranging for such an exchange is permissible under Section 1031 even if it is done for tax purposes. Compare DeCleene v. Commissioner, 115 T.C. No. 34 (2000). The transaction in Boise Cascade Corp. predated Section 1031(f) and Treas. Reg. Sections 1.1502-80(f) and 1.1502-13 which would now apply if a related party sold (instead of leased) the land to an unrelated accommodator and the land was subsequently exchanged with the taxpayer.

Both the IRS and the court in Boise Cascade Corp. recognized that separate taxable entities were involved, even though they were a parent and subsidiary corporation. The court rejected any theory based on “one economic family” (as suggested above) in analyzing the substance of the transaction. Rather, the court found that the substance of the transaction was an exchange of like-kind property since the unrelated buyer acquired and held fee title to the replacement property and thus had like-kind property to exchange with the taxpayer. This fundamentally distinguished the case from the Seventh Circuit’s core holding in Bloomington Coca-Cola Bottling Co., v. Commissioner, 189 F.2d 14, 16 (7th Cir. 1951) in which the court stated: “But this is **not** a case where the contractor exchanged a completed plant owned by the contractor for property and money, hence the contractor or **at no time** had like-kind property . . .” [Emphasis added.] In Bloomington Coca-Cola Bottling Co., the form of the transaction was a construction contract and the contractor was engaged to construct a new bottling plant on land owned by the taxpayer. Under the contract, the contractor furnished the necessary material and labor, completed the new building at a price of \$72,500, and was paid \$64,500 in cash and received the taxpayer’s old plant valued at \$8,000. The contractor simply performed construction services and never had like-kind property to exchange with the taxpayer. We now examine other applicable cases and rulings and turn to a more general discussion of exchanges involving leasehold interests, including build-to-suit exchanges.

Like-Kind Rules for Leasehold Interests. PLR 200251008 involves the creative use of “split ownership” and leasehold interests by related parties in connection with a build-to-suit exchange. Acquiring a long-term leasehold interest as replacement property in an exchange may provide a variety of legal, financial, accounting, and tax benefits. In PLR 200251008, the taxpayer was able to relocate its business and have improvements made on land already leased to related parties through a Section 1031 exchange. Split ownership may also provide estate tax benefits. For example, the fee interest may be purchased for cash outside of the exchange by the taxpayer’s heirs so that the residual value of the property is not included in the taxpayer’s gross estate. The taxpayer can still defer capital gains taxes by acquiring a long-term leasehold interest in the exchange. At the same, the taxpayer can minimize the amount ultimately included in his

gross estate (i.e., the value of the leasehold interest at date of death).

Under long-standing regulations, a fee in land is of a like kind to a leasehold of land with a remaining term of 30 years or more. See Treas. Reg. Section 1.1031(a)-1(c)(2); Century Electric Co. v. Commissioner, 192 F.2d 155 (8th 1951), cert. denied, 342 U.S. 954 (1952) (fee for 95-year lease in same property). If the lease provides for optional renewal periods, they are included in determining whether the leasehold has 30 years or more to run. R & J Furniture Co. v. Commissioner, 20 T.C. 857 (1953), 1954-1 C.B. 6 (lease with initial term of 5 years and ten optional renewal periods of 5 years each held to be of like kind to a fee since the taxpayer had the right to use the property for up to 55 years); Rev. Rul 78-72, 1978-1 C.B. 258 (leasehold interest with initial term of 25 years and three 10-year renewal periods held to be of like kind to a fee since the optional renewal periods are included for purposes of the 30-year requirement); PLR 9126007 (6/28/91) (below-market, readily-renewable, 10-year lease treated as longer than a 30-year lease and of like kind to a fee interest because of its “assured renewability”). It is unclear if a lease with less than 30 years to run can be extended to beyond 30 years and then exchanged by the lessee for a fee. The lessee may not have held like-kind interest for the requisite holding period if the lease is extended immediately before the exchange. However, a taxpayer should be able to exchange a fee for a leasehold of 30 years or more if the seller of the leasehold in a bona fide arm’s length transaction extends the term to beyond 30 years immediately before the exchange to meet the taxpayer’s exchange requirements.

Different kinds of leasehold interests may be involved in an exchange. The taxpayer may receive as replacement property a pre-existing leasehold in property where the taxpayer already owns the fee or other reversionary interest. The taxpayer may exchange the fee interest in relinquished property for a long-term leasehold as replacement property in the same property. See Rev. Rul. 68-394, 1968-2 C.B. 338. The taxpayer can transfer a fee for the receipt of a newly or recently created leasehold interest with 30 years or more to run. See Rev. Rul. 66-209, 1966-2, C.B. 299; PLR 9110007 (11/26/90). However, the granting of a new lease by a taxpayer-lessor in exchange for property is not treated as a like-kind exchange, but is treated as the receipt of

advance rental income by the taxpayer-lessor in an amount equal to the equity value of the property received. Pembroke v. Helvering, 23 B.T.A. 1176 (1931), aff'd, 70 F.2d 850 (D.C. 1934); Crooks v. Commissioner, 92 T.C. 816 (1989). Compare PLR 8008113 (exchange of shopping center improvements for fee interest in other property was treated as a like-kind exchange, although the taxpayer separately leased the land underlying the improvements for 35 years at a market rental rate to the party acquiring the improvements).

It may be possible to avoid the result in Pembroke and Crooks by granting a lease to a related entity and having the related entity exchange the leasehold interest for real property. This was done in PLR 9110007 by the fee owner of the replacement property, but the fee owner was not the taxpayer-exchanger requesting the ruling. The step-transaction doctrine may also apply to a taxpayer-lessor attempting to avoid prepaid rent in this way. On the other hand, a lessor can make a Section 1031 exchange of his “reversionary interest” in leased property (the relinquished property) while retaining the “rental interest” in the relinquished property for the term of the lease. PLR 9224008 (3/6/92). The problem presented by Pembroke and Crooks (i.e., the granting of a lease is not a sale or exchange by the lessor) is not present if a taxpayer receives a newly-created lease as the lessee. Further, if an accommodator enters into a newly-created lease, the exchange that counts is the exchange between the accommodator and the taxpayer, which will involve an existing leasehold interest.

By negative implication from the example in the regulations, if a leasehold has an unexpired term of less than 30 years, it is not of like kind to a fee. See Standard Envelope Manufacturing Co. v. Commissioner, 15 T.C. 41 (1950), acq. 1950-2 C.B. 4 (25-year leasehold is not of like kind to a fee); May Department Stores v. Commissioner, 16 T.C. 547 (1951) (a 20-year lease not of like kind to a fee); Rev. Rul. 83-70, 1983-1 C.B. 189 (15-year lease not of like kind to a fee); PLR 8319011 (leasehold in motel property with 23 years to run is not of like kind to a leasehold with a term of 30 or more years or a fee in other motel property). If short-term leasehold interests are exchanged for one another, it is unclear how similar the short-term

leasehold interests must be. Compare Rev. Rul. 76-301, 1976-2 C.B. 241 (leasehold with about 27.5 years to run in 20 floors for sublease of identical term in 5 floors of the same building) with PLR 8319011 (leasehold in motel property with 23 years to run replaced by golf course leasehold with an unspecified term of less than 30 years). See also PLR 8004133 (leasehold with 15 years to run, when increased by an option to renew for 10 years, is similar to a lease with a term of 25 years for purposes of Section 1033(a)(3)(A)); Everett v. Commissioner, T.C. Memo 1978-53 (rights to remove timber on approximately 5,000 acres for three and six years under timber lease exchanged for rights to remove timber on approximately 24,000 acres for 10 years).

Creating Value in a Leasehold. Value in a leasehold interest may pre-exist or be created. If a long-term leasehold provides for an arm's length rental rate, it may qualify as replacement property but it would have limited separate value. If an existing leasehold provides for a below-market rental rate, a significant value may be allocated to it. In a transaction with a QI, a taxpayer may direct the QI to enter into a long-term leasehold with the fee owner of replacement property and to use exchange funds to "prepay" a portion of the rent by way of a lease acquisition payment. Thereafter the QI can transfer the now below-market leasehold interest to the taxpayer to complete the exchange. The landlord will have ordinary income from prepaid rent. The same type of transaction can be structured with an EAT in a reverse exchange under the safe harbor provisions of Rev. Proc. 2000-37. Finally, a QI, an EAT, or another exchange accommodation party may enter into a long-term ground lease and then construct and own a building as a leasehold improvement. The value from the leasehold interest arises from the lessee's ownership of the leasehold improvements.

Build-to-Suit Exchanges Involving Leaseholds. In PLR 9110007 (11/20/90) and PLR 9149018 (9/4/91), the IRS approved transactions in which an accommodator, prior to and in anticipation of an exchange, acquired a leasehold interest in land with 30 or more years to run from an unrelated lessor and constructed improvements thereon to the taxpayer's specifications. Each ruling holds that the taxpayer's exchange of relinquished property for the accommodator's leasehold in other land and the newly constructed building qualifies as a Section 1031 exchange.

So long as the stated term of the acquired leasehold equals or exceeds 30 years, the leasehold and improvements will be treated as of like kind to a fee interest. In PLR 9110007, the 51-year leasehold interest received in the exchange qualified as like kind property, even though it was subject to an option held by the fee owner to buy back the leasehold and building if specified events occurred. Further, as long as the accommodator is not the taxpayer's agent, the case law has permitted taxpayers great latitude in supervising construction activities and bearing the risk of cost overruns in qualifying Section 1031 transactions. See, e.g., Boise Cascade Corp. v. Commissioner, 33 T.C.M. 1443 (1974).

Use of QIs and EATs. In a deferred exchange in which a QI enters into a long-term lease, constructs improvements during the 180-day period, and thereafter transfers the leasehold interest and leasehold improvements to the taxpayer, the transaction should comply with the requirements of the QI safe harbor. By entering into a lease of 30 or more years, the QI will acquire a fee-equivalent interest in the replacement property. By entering into the relevant construction contracts and making the required payments thereunder, the QI will become the legal owner of the leasehold improvements. The QI will ultimately transfer legal title to the leasehold interest and improvements to the taxpayer by way of appropriate assignments and other instruments of transfer. Since the QI will acquire and transfer legal title to the leasehold interest and improvements in a "safe harbor" transaction, it should not be necessary to consider whether the QI did so as the taxpayer's agent or otherwise maintained sufficient benefits and burdens of ownership under general tax principles. The same result should be true for an EAT in a safe harbor "reverse" exchange. Rev. Proc. 2000-37 provides that so long as the EAT obtains "qualified indicia of ownership" and transfers the property to the taxpayer within 180 days, the IRS will not challenge the treatment of the EAT as the beneficial owner of such property. PLR 200251008 confirms that legal title to the leasehold interest and the improvements satisfies the qualified indicia of ownership test.

Using a QI or an EAT to acquire a newly-created lease may be problematic because the intermediary may be leery of becoming a party to and having obligations under a long-term lease.

In PLR 200251008, this problem was solved by having Titleholder (a single-asset, single-member LLC owned by the EAT) enter into the lease and construct improvements. Another solution might be for the fee owner to enter into a lease with the intermediary that could be assigned within six months to the exchanger, extinguishing all further liability of the intermediary thereunder, or alternatively, that could be cancelled after 180 days by the intermediary. The exchanger may be asked to guarantee some or all of the intermediary's obligations, and probably would need to indemnify the fee owner for demolition costs with respect to improvements made by the

intermediary. In any event, a QI or an EAT will want to ensure that it is not fully liable for the entire term of the lease after the assignment of the lease to the taxpayer.

Acquiring Leasehold in Taxpayer's Property. An existing long-term leasehold interest in the taxpayer's property may be acquired as replacement property. In PLR 9543038 (7/31/95), the IRS relied upon Rev. Rul. 68-394, supra, in concluding that a taxpayer could use the condemnation proceeds from real property to acquire two existing long-term leasehold interests held by the taxpayer's subsidiary corporation in other real property as to which the taxpayer owned the fee. The taxpayer represented that the leasehold interests would be acquired in an arm's length transaction based upon the valuation of an independent appraiser. The IRS applied the like-kind test under Section 1033(g), which applies the same test as Section 1031. (Section 1033(i) no longer allows taxpayers to acquire replacement property from a related party following an involuntary conversion).

The holdings in Rev. Rul. 68-34 and PLR 9543038 are consistent with the holdings of other rulings in which the IRS recognized that separate "like-kind" interests may exist with respect to the same parcel of real property. For example, in PLR 7932068 (5/11/79), the IRS held that a taxpayer's transfer of a fee interest in a portion of land which the taxpayer had leased to a second party in exchange for the termination of such leaseholds (which had remaining terms of more than 30 years) qualified as a like-kind exchange. Similarly, Rev. Rul. 76-301, 1976-2 C.B.

241, held that a taxpayer's exchange of its leasehold interest in an entire building and improvements for cash and an identical sub-leasehold interest in a portion of the building constitutes a like-kind exchange on which the taxpayer may not recognize a loss. In PLR 9620010 (2/13/96), the IRS approved reinvestment of condemnation proceeds from a fee interest in land in replacement land and improvements notwithstanding the taxpayer's ownership of a lessee's interest in the replacement property.

Leasehold Improvements on Taxpayer's Property. In one older PLR, the IRS held that a taxpayer could exchange one parcel of real property for a newly-created, greater-than-30-year leasehold interest and leasehold improvements on another parcel owned in fee by the taxpayer. PLR 8304022 (10/22/82). The leasehold improvements were constructed by an unrelated contractor who became the lessee under a new long-term lease of the taxpayer's land. The unrelated contractor was also the transferee of the taxpayer's relinquished property. The IRS ruled favorably even though the lease provided for a fixed rent of \$1.00 per year and the taxpayer acknowledged that the contractor entered into the lease "only for the purpose of facilitating the exchange" and that "the lease terminates if the exchange agreement terminates." The taxpayer did represent, however, that the contractor "will construct the garage on his own behalf and not as an agent of [the taxpayer]." See also PLR 7823035 (3/9/78) (IRS approved an exchange in which the buyer purchased land from the taxpayer, constructed improvements on the land, and exchanged the improved land for other property owned by the taxpayer).

PLR 8304022 is the only ruling to address an exchange in which the replacement property is a newly-created leasehold interest together with leasehold improvements constructed on land owned in fee by the taxpayer. This is not only an older private letter ruling but also there is no analysis of the effect, if any, of the taxpayer's prior and continuing ownership of the fee interest in the replacement property and the applicability of the substance-over-form or step-transaction doctrines to the transaction. For that reason, it is possible that the IRS might reconsider its holding in PLR 8304022 in analyzing a similar transaction today. In particular, the IRS might seek to recharacterize such a transaction as a non-like-kind exchange of real property for

“production services” or improvements alone on land already owned by the taxpayer. See Bloomington Coca-Cola Bottling Company v. Commissioner, T.C.M. 50-608, aff’d, 189 F.2d 14 (7th Cir. 1951) and Reg. Section 1.1031(k)-1(e)(4). See also PLR 9243038 (the IRS mentioned but did not apply the step-transaction doctrine where there was a seven-year period in between the granting of a 90-year ground lease and the subsequent exchange for the leasehold interest and improvements on the land owned by the taxpayer, and where there was no binding obligation to make the exchange at the time of the lease). But PLR 200251008 indicates that the IRS may not consider or apply these judicial doctrines at least where (1) there is a business purpose for the transaction (i.e., the taxpayer’s business relocation), (2) the lease is at a market rental rate and is not transitory, and (3) the land is owned by or leased to a related party (not the taxpayer itself).

If the taxpayer sells (instead of leases) the land to the accommodator, the transaction may be the most vulnerable to an IRS challenge. An IRS attack most likely would use the same step-transaction approach that the IRS prevailed with in DeCleene v. Commissioner, 115 T.C. No. 34 (2000). See also Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976). After their purported exchanges, the taxpayers in DeCleene and Smith ultimately ended up with cash and with property that they previously owned. The application of the step-transaction doctrine to find a taxable sale was not surprising in these cases. If the taxpayer receives a leasehold interest and leasehold improvements as replacement property (and no cash), the transaction may seem less abusive but it is still susceptible to a challenge as an exchange of property for construction services following Bloomington Coca-Cola Bottling Co., supra. See also PLR 8921058 (2/27/89), revoking PLR 8847042 in which the IRS originally approved an exchange of property with a contractor for a townhouse constructed on land previously owned by the taxpayer. PLR 8921058 revoked PLR 8847042 because the IRS was concerned that the transaction was, in substance, an exchange of property for construction services. Compare Boise Cascade Corp. v. Commissioner, 33 T.C.M. 1443 (1974) (taxpayer’s receipt of replacement property which was improved while an unrelated buyer held fee title qualified under Section 1031, although replacement property was previously owned by taxpayer’s parent company, was sold to the buyer in anticipation of an exchange, was

leased back to parent company for 15 years with an option to repurchase it, and parent company supervised construction and was responsible for cost overruns).

In all cases where the replacement property was previously owned by the taxpayer and improvements are made after either a sale of the property or the granting of a long-term leasehold interest to the accommodator, we continue to believe that there is a substantial risk that the IRS or a court will disqualify the exchange as a transfer of property for construction services. Granting a long-term leasehold to the accommodator on taxpayer-owned property may be less risky than a sale from a legal perspective since the taxpayer retains ownership of the fee, but it presents similar tax risks. Granting a long-term leasehold to an accommodator on land owned by or leased to a related party (not the taxpayer itself) now seems to be the least risky of these alternatives in light of the IRS's holding in PLR 200251008.

LKE Programs

The IRS issued five new PLRs concerning LKE Programs. In these programs taxpayers engage in ongoing deferred exchanges of motor vehicles or other tangible personal property using a single QI. PLRs 200242009 (leased vehicles), 200241016 (leased equipment), 200241013 (leased vehicles), 200240049 (leased vehicles) and PLR 200236026 (equipment used in business). Previously, the IRS issued six PLRs on LKE Programs. See PLRs 200109022 (equipment in General Asset Classes), 9826033 (leased property in Product Class), 9812013 (leased property in Product Class), 9627014 (vehicles of car rental agency in General Asset Classes), 9448010 (leased equipment) and 9447008 (vehicles of car rental agency in General Asset Classes). In light of these PLRs and continuing requests, some commentators have written to the IRS and requested general guidance in the form of a revenue procedure on LKE Programs. The commentators argue that such guidance would result in the consistent treatment of similarly situated taxpayers and avoid the time-consuming PLR process. See letter dated April 1, 2002 by Fred T. Goldberg, Jr. and Jody J. Brewster to Treasury and the IRS concerning LKE Programs and Request for Published Guidance. A copy of the revenue procedure proposed in the Goldberg and Brewster letter follows our discussion of LKE Programs and the five new PLRs.

Characteristics of LKE Programs. As noted in the Goldberg and Brewster letter, LKE Programs typically have most or all of the following features:

(1) the taxpayer regularly and routinely enters into agreements to sell motor vehicles or other tangible personal property and agreements to buy motor vehicles or other tangible personal property;

(2) the taxpayer uses a single, unrelated intermediary to accomplish the exchanges;

(3) the taxpayer and the intermediary enter into a written master exchange agreement;

(4) the master exchange agreement expressly limits the taxpayer's rights to receive, pledge, or borrow or otherwise obtain the benefits of money or other property held by the intermediary as provided in Treas. Reg. Section 1.1031(k)-1(g)(6);

(5) in the master exchange agreement, the taxpayer assigns to the intermediary the taxpayers' rights (but not its obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property;

(6) the taxpayer provides written notice of the assignment to the other party to each existing and future agreement to sell relinquished property and/or to purchase replacement property;

(7) pursuant to those existing and future agreements, the relinquished properties are transferred directly from the taxpayer to the purchasers of the properties and the replacement properties are transferred directly to the taxpayer from the sellers of those properties;

(8) the taxpayer (i) has a process for identifying replacement property before the end of the

identification period for the relinquished property or group of relinquished properties, (ii) automatically complies with the identification requirement by receiving replacement property before the end of the 45-day identification period, or (iii) uses a combination of (i) and (ii);

(9) the taxpayer has a process for collecting funds (which may include the use of joint taxpayer and intermediary bank accounts, or accounts in the name of a third party for the benefit of both the taxpayer and the intermediary, to collect funds from a number of sources and to separate those funds) that ensures that the intermediary receives all of the funds to which the intermediary is entitled (i.e., proceeds from the sale of relinquished properties) and the taxpayer only receives funds to which the taxpayer is entitled (i.e., all other funds);

10) the taxpayer has a process for disbursing funds (which may include the use of joint taxpayer and intermediary bank accounts, or accounts in the name of a third party for the benefit of both the taxpayer and the intermediary, to disburse funds from a number of sources for various purposes) that ensures that the intermediary controls the disbursements of all of the funds it holds (i.e., proceeds from the sale of relinquished properties and any interest or growth factor attributable to those amounts) and the taxpayer only controls the disbursement of its funds (i.e., all other funds);

(11) funds held by the intermediary (i.e., proceeds from the sale of relinquished properties and by interest or growth factor attributable to those amounts) are used to purchase replacement property which is transferred to the taxpayer or may be released to the taxpayer to the extent permitted under Treas. Reg. Section 1.1031(k)-1(g)(6);

(12) each relinquished property or each group of relinquished properties is matched with replacement property or a group of replacement properties (including replacement properties received before the end of the 45-day identification period) in order to determine the gain, if any, recognized in connection with the disposition of the relinquished property and to determine the

basis of the replacement property;

(13) for various reasons, all relinquished properties and all potential replacement properties may not be matched, and the taxpayer will recognize any gain or loss realized on the disposition of unmatched relinquished property and will have a cost basis in any unmatched replacement property; and

(14) the taxpayer may provide various financial services in the ordinary course of its business to purchasers of relinquished property and sellers of replacement property (e.g., it may offer to

finance at market terms a buyer's purchase of relinquished property and it may have provided financing at market terms to the seller of replacement property).

Within these general characteristics, LKE Programs may have special features, depending on the types of property involved, the mechanics of the sales and purchases, the business practices of the taxpayer, relationships with dealers and financial institutions, and systems used by the QI. These special features may include different methods of segregating and matching assets of different classes and related funds, identifying replacement property, providing written notice of assignments to purchasers and sellers, using a web-based system as in PLR 200236026, holding and disbursing funds with the QI's authorization, handling separate loan transactions, and settling receivables and payables of the QI. Sophisticated computer programs may be used to match relinquished and replacement properties in order to minimize recognition of gain. See PLR 200109022 discussed below. In PLR 200241016, the taxpayer (a lower-tier subsidiary) maintained a portfolio of equipment manufactured by its parent or another subsidiary. The taxpayer purchased the equipment from unrelated dealers, leased it to third parties, and later disposed of it. The equipment that the dealers purchased from the parent or another subsidiary subsequently became the taxpayer's replacement property. No issue was raised under the related party exchange rules or consolidated return regulations.

IRS's Holdings. Although each LKE Program in the five PLRs had certain differences, the rulings consistently concluded:

1. **Separate Exchanges.** Each match of relinquished property with like-kind replacement property acquired in the 45-day identification period constituted a separate and distinct exchange transaction. The taxpayers in the rulings represented that each match was made within the 45-day identification period (PLRs 200242009, 200241013 and 200240049). Thus, the taxpayer's match of one relinquished vehicle to one replacement vehicle acquired in the 45-day period would be respected by the IRS as a separate exchange for gain recognition and basis-tracking purposes, and not treated as part of a larger exchange of multiple properties. Further, the failure of any particular exchange to qualify under Section 1031, including any unmatched relinquished property, would not affect the other exchanges, and unmatched replacement property would simply receive a cost basis. In PLR 200236026 and some earlier PLRs (PLR 9627014 and 9447008), the taxpayer represented that certain specified "batches" of like-kind property would be exchanged. In 20019022, a like-kind matching system was used that matched relinquished property only to like-kind replacement property acquired within the 45-day period after the transfer of that relinquished property. This ruling did not state precisely when the match was made or recorded. In the Goldberg and Brewster letter, they contend that the date on which properties are matched should not be determinative as long as the replacement property is in fact received within the 45-day period. If this view is correct, matches may be made and recorded after the 45-day identification period.

2. **Check Processing.** The taxpayer is not in actual or constructive receipt of checks written by purchasers of relinquished property where the checks are initially received, recorded and processed by the taxpayer (PLRs 200242009, 200241013 and 200240049). The checks must be made payable to the QI and promptly delivered to the QI, and all agreements governing the flow of funds must expressly limit the taxpayer's rights and ability to actually or constructively receive those funds in accordance with Treas. Reg. Section 1.1031(k)-1(g)(6).

3. **Bank Accounts**. The taxpayer is not in actual or constructive receipt of funds in a joint escrow account or an account held by a QI where the agreements contain the express restrictions on the taxpayer's rights required by the deferred exchange regulations, the QI's authorization is necessary to disburse funds that represent sales proceeds from relinquished property, and the taxpayer does not have "unfettered discretion" to disburse those funds. Within these parameters, the taxpayer may (i) receive interest or other earnings on exchange funds and direct the investment of funds in an investment account (PLR 200240049); (ii) write checks on the disbursement account to sellers of replacement property with the QI's authorization (PLR 200240049); and (iii) direct the transfer of funds between subaccounts established for different classes of relinquished

property, but all exchange credits must ultimately balance on a property-by-property basis (PLR 200241016).

4. **Security Deposits**. The taxpayer is not considered in actual or constructive receipt of sales proceeds in the form of previously received security deposits where a buyer-lessee directs that the security deposit be credited against the purchase price for relinquished property, and where the taxpayer pays the security deposit to the QI, together with the lessee's check for the balance of the purchase price (PLR 200242009). This same rationale might apply to lessors of real estate who hold security deposits.

5. **Loan Transactions**. An affiliate of the taxpayer may loan funds to the buyer for the purchase of the relinquished property and pay the loan proceeds to the QI as part of the purchase price. In such cases, the buyer's note is received in a separate loan transaction and is not considered money or other property received by the taxpayer or a disqualified person in the exchange (PLRs 200242009 and 200241016).

6. **Conversion of Receivables/Payables**. Receivables from a purchaser of relinquished property and payables to a seller of replacement property may be settled between the QI and an

affiliate of the taxpayer in cash at face value, as long as the conversion results in no net economic benefit to the affiliate or the taxpayer (PLR 200241016). PLR 200241016 further states: “A transaction between a taxpayer and a qualified intermediary which produces no net benefit to the taxpayer is not considered to violate these strictures [the (g)(6) and other restrictions on the taxpayer’s rights or immediate ability to receive, pledge, borrow or otherwise obtain the benefits of money or other property].” The same rationale may apply to a QI’s assignment of a buyer’s installment note to the taxpayer or an affiliate for cash at face value.

7. **Qualified Intermediary**. An intermediary does not fail to be a QI solely because of any of the following: (i) assigns the taxpayer’s rights to sell all of the taxpayer’s old property and to purchase all of the taxpayer’s new property and receives and disburses all related funds, including property and funds that are not matched under the LKE program (PLRs 200242009, 200241013 and 200240049); (ii) using anticipatory, blanket assignments in the master exchange agreements of the taxpayer’s rights to sell and purchase property, which are deemed to satisfy the assignment safe harbor of Treas. Reg. 1.1031(k)-1(g)(4)(v) as long as written notice of the assignment is given to each purchaser and seller before the transfer (all of the above rulings); (iii) providing written notice of the assignment through email in accordance with the Electronic Signatures in Global and National Commerce Act (PLR 200236026); (iv) using a financial institution as a QI or qualified escrow account holder that previously or currently provides “routine financial services” to the taxpayer, including purchasing new property on behalf of the taxpayer that is not matched to relinquished property (PLRs 200242009, 200241016, 200241013 and 200240049).

8. **Qualified Use**. The mass leasing of personal property to third parties is treated as a qualified use under Section 1031, and is considered property held by the taxpayer for productive use in a trade or business. The use of such property is not deemed to change for purposes of Section 1031 when the taxpayer disposes of such property. Thus, the personal property is not treated as stock in trade or other property held primarily for sale, even if the taxpayer “regularly” disposes of such property (all of the above rulings).

9. **Like-kind Personal Property.** Equipment within the same Product Class under the SIC Manual is treated as property of like class and, therefore, as like-kind property (PLR 200241016 and 200236026). Separate subaccounts and exchanges may be used for relinquished equipment that is within a different Product Class (PLR 20024016). Certain leased vehicles may not fall within the General Asset Class or Product Class safe harbors under Treas. Reg. Section 1.1031(a)-2(b). Thus, the general like-kind rule applies under Treas. Reg. Section 1.1031(a)-2(a). The like-kind test for personal property is restrictive. The IRS cited California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982) (gold coins and Swiss francs held not to be of like kind). Treas. Reg. Section 1.1031(a)-1(c) provides that “a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose” are like-kind properties. See also Phillips & Rocca, “Summary of Recent Section 1031 Cases, Rulings and Advices” (13th Annual NRDC Conference) (April 27, 2000) at 40-42 (citing cases of like-kind personal property exchanges, including car for car, bus for bus, truck for truck, etc.). Accordingly, the IRS ruled that automobiles, passenger vans and SUVs are considered like-kind property with differences only in grade or quality. But a truck (including a light-duty truck) is considered “different in nature or character” than an automobile and these vehicles are not like-kind property (PLRs 200242009, 200241013 and 200240049).

Issues in LKE Programs.

Matching. In a LKE Program, the taxpayer’s transfer of each relinquished property or group of relinquished properties and the taxpayer’s corresponding receipt of each replacement property or group of replacement properties with which the relinquished property or properties are matched constitute a separate and distinct exchange for purposes of Section 1031. Some commentators have pointed out that replacement property may not be matched with relinquished property until after the relinquished property has been transferred and the replacement property has been received. They contend that fact should not result in the transfer and receipt of the properties failing to qualify as an exchange under Section 1031. So long as replacement property

is in fact received within the 45-day identification period or is otherwise properly identified and received as required by Section 1031, they believe that the time at which such replacement property is matched with relinquished property should not matter. Without any time limit on when a match must occur, the taxpayer presumably would have up until the filing of the tax return for the year of the transfer of the relinquished property to match replacement property acquired during the 45-day identification period. The rulings to date do not specifically address when a match must occur and whether matches can be made after the applicable 45-day identification period for replacement property acquired during that period.

Contract Assignments. The deferred exchange regulations provide that an intermediary will be treated as acquiring and/or transferring property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement for the acquisition or transfer of property and, pursuant to that agreement, the property is transferred. Treas. Reg. Section 1.1031(k)-1(g)(4)(iv)(B) and (C). An intermediary will be treated as entering into an agreement for the acquisition or transfer of property if the taxpayer's rights in the agreement are assigned to the intermediary, and the other parties to the acquisition or transfer agreement are notified in writing of the assignment on or before the date of the relevant transfer of property (the "Assignment Safe Harbor"). Treas. Reg. Section 1.1031(k)-1(g)(4)(v). Under the Assignment Safe Harbor, an assignment is required of only the rights in the agreement; there is no requirement that the taxpayer also assign or delegate its obligations arising under the agreement. Anticipatory, blanket assignments of contract rights are a common commercial practice, and are particularly appropriate and necessary in LKE Programs due to the volume, frequency and speed with which the transactions occur. The PLRs have ruled that a taxpayer may satisfy the Assignment Safe Harbor through an anticipatory, blanket assignment in the master exchange agreement of the taxpayer's rights in existing and future agreements for the purchase or sale of properties and by subsequently giving written notice of that assignment to each purchaser and seller.

Disqualified Person. A taxpayer who engages in an LKE Program may assign to the

intermediary the taxpayer's rights in all of its existing and future agreements to purchase and/or sell properties of a particular type. However, some of the properties acquired or transferred pursuant to those agreements may not end up being included in a like-kind exchange (e.g., in the case of relinquished properties that are not matched with replacement properties, or in the case of replacement properties that are not matched with relinquished properties). The taxpayer will recognize gain or loss on the disposition of relinquished properties that are not included in a like-kind exchange and will take a cost basis in replacement properties that are not included in a like-kind exchange.

In several PLRs, the IRS has concluded that an intermediary will not be a disqualified person even though the taxpayer assigns to the intermediary the taxpayer's rights in its agreements to purchase replacement property that ultimately was not matched with relinquished property under the taxpayer's LKE Program. In such a case, the taxpayer intends that the transfer of each relinquished property and the receipt of each replacement property be part of an exchange that qualifies for nonrecognition of gain or loss under Section 1031. The mere fact that some of the replacement properties were not matched with relinquished properties is not inconsistent with the taxpayer's intention. Thus, the intermediary's involvement in those transactions is appropriately not taken into account in determining whether the intermediary is a disqualified person. The IRS's conclusion in the PLRs is consistent with the principles set forth in Treas. Reg. Section 1.1031(j) (the "multiple asset exchange" regulations). The multiple asset exchange regulations specifically envision that, in the case of a multiple asset exchange, assets may be transferred or received by the taxpayer that will not qualify for nonrecognition treatment under Section 1031, and instead will be subject to taxation under Section 1001.

In the case of an intermediary that is a financial institution, the IRS's conclusion in the PLRs is also consistent with Treas. Reg. Section 1.1031(k)-1(k)(2)(ii). That regulation provides that, for purposes of determining whether the intermediary is the agent of the taxpayer, performance by such an intermediary of "routine financial services" is disregarded. The service performed by the intermediary in connection with purchasing replacement property that

ultimately is not matched with relinquished property involves payment of the purchase price for the property. Such a service is a “routine” financial service, and the IRS has ruled that it should not be taken into account in determining whether such an intermediary is the agent of the taxpayer. The same analysis applies to the situation where the taxpayer assigns to the QI the taxpayer’s rights in its agreements to sell relinquished properties that ultimately are not matched with replacement properties under the taxpayer’s LKE Program. Thus, the IRS has ruled that a QI (at least one that is a financial institution) may receive funds with respect to the transfer of unmatched relinquished properties and pay funds with respect to the acquisition of unmatched replacement properties under the taxpayer’s LKE Program, so that all sales and purchases can be effected through one system with the QI.

Joint Taxpayer-Qualified Intermediary Accounts. Taxpayers engaged in LKE Programs have a process for sorting proceeds from the sale of relinquished properties from all other types of payments collected by the taxpayer in the course of its business. The process ensures that the intermediary receives proceeds from the sale of relinquished properties, and the taxpayer receives all other funds. Some taxpayers accomplish this sorting process through one or more joint taxpayer-qualified intermediary bank accounts, trust accounts, or escrow accounts, or through an account in the name of a third party but for the benefit of both the taxpayer and the qualified intermediary (collectively “joint taxpayer-qualified intermediary accounts”). Pursuant to the terms of an agreement among the taxpayer, the QI and the financial institution, escrow agent or trustee, all proceeds from the sale of relinquished properties belong to and are held for the benefit of the QI, and the taxpayer has no rights to receive, pledge, borrow or otherwise obtain the benefits of these proceeds. All other funds in the account belong to and are held for the benefit of the taxpayer. Using information provided by the taxpayer, the funds in these accounts are sorted, and pursuant to the agreement between the parties, the QI receives all proceeds from the sale of relinquished property and the taxpayer receives all other funds. PLR 200241016 indicates that a taxpayer does not have actual or constructive receipt of funds in such a joint taxpayer-qualified intermediary account or comparable arrangement.

In addition to using a joint taxpayer-qualified intermediary account in connection with the collection of funds, taxpayers engaged in LKE Programs may also use a similar account in connection with the disbursement of funds. Business realities make a single payment more practical even though there are multiple sources of funds that make up the payment. For example, where the proceeds from the sale of a relinquished property are not sufficient to pay the entire purchase price of a replacement property, the taxpayer may provide additional funds to make up the difference, with a single payment going to the seller of the replacement property. The taxpayer may have a process for combining multiple amounts from various sources into a single payment. Some taxpayers accomplish this by using one or more joint taxpayer-qualified intermediary bank accounts, escrow accounts or trust accounts. The QI controls the disbursement of all of its funds (i.e., proceeds from the sale of relinquished properties and any interest or growth factor attributable to those amounts) and the taxpayer controls the disbursement of its funds (i.e., all other funds). The agreement among the taxpayer, the QI and the financial institution, escrow agent or trustee specifies the rights and obligations of the taxpayer and the QI, and specifically provides that the taxpayer has no rights to receive, pledge, borrow or otherwise obtain the benefits of the funds held on behalf of the QI. Pursuant to the agreement, the financial institution, escrow agent or trustee disburses funds controlled by the QI only after receiving authorization from the QI. Several PLRs confirm that a taxpayer does not have actual or constructive receipt of funds held by the qualified intermediary or in such a joint taxpayer-qualified intermediary account or other comparable arrangement used for disbursing funds.

Processing Payments. Many taxpayers with LKE Programs are in the business of leasing. An important function performed by a taxpayer in the business of leasing is the day-to-day processing of lease and other payments called for under the lease agreement. In its capacity as “servicer,” the taxpayer opens envelopes from lessees, deposits checks, and records payments to lessees’ accounts. The taxpayer may also process numerous other kinds of payments related to its leasing business (e.g., sales proceeds, insurance proceeds, late charges, excess mileage fees, wear and tear fees, termination fees, sales and property taxes, etc.). In addition, the taxpayer may also

process payments in connection with other lines of business in which the taxpayer is engaged. Business realities may require that all payments be sent to one or more central locations for processing and sorting. Several PLRs have ruled that the taxpayer's processing of a check made payable to a person other than the taxpayer does not constitute actual or constructive receipt of the amount represented by the check because the taxpayer has no right to cash the check or to deposit the check into an account of or for the benefit of the taxpayer.

Loans to Purchasers of Relinquished Property. A taxpayer with an LKE Program may provide various financial services in the ordinary course of its business. For example, the taxpayer may offer to finance a buyer's purchase of relinquished property and it may have provided financing to the seller of the replacement property. Where the taxpayer acts as the finance company that lends money to the buyer of the relinquished property, the taxpayer's receipt of the buyer's promissory note or other evidence of indebtedness should not result in actual or constructive receipt of the sales proceeds. Under these circumstances, the taxpayer is acting in two separate roles; in one, it is the seller of relinquished property and, in the other, it is the lender financing the purchase. Several PLRs have indicated that the receipt of the purchaser's note or other evidence of indebtedness does not result in the taxpayer actually or constructively receiving sales proceeds where the taxpayer promptly delivers funds equal to the loan proceeds to or for the benefit of the QI. See also 124 Front Street v. Commissioner, 65 T.C. 6 (1975), acq. 1976-2 C.B. 2; Biggs v. Commissioner, 69 T.C. 905 (1978), aff'd 632 F.2d 1171 (5th Cir. 1980).

Application of Lease Security Deposit to Purchase Price. At times, a lessee who purchases the taxpayer's relinquished property may ask to have its lease security deposit applied toward the purchase price, with the taxpayer delivering the lease security deposit to the QI to be used to purchase replacement property. Several PLRs have held that the application of a purchaser's lease security deposit against the purchase price of the taxpayer's relinquished property does not constitute actual or constructive receipt of the lease deposit by the taxpayer, where the taxpayer promptly delivers funds equal to the lease security deposit to or for the benefit of the QI.

Given the number of taxpayers engaging in LKE Programs and the time-consuming and resource-intensive nature of PLRs for both taxpayers and the IRS, certain commentators have written to the IRS and argued that it is in the best interests of taxpayers and the government for the IRS to provide general guidance as to the application of Section 1031 to LKE Programs. This would result in the consistent application of rules and free up valuable resources now being used to address these issues one taxpayer at a time through the IRS's PLR program. The commentators requested that a project to publish such guidance be included on the 2002 guidance priority list. The following proposed revenue procedure was included in the April 1, 2002 letter by Goldberg and Brewster referenced above.

Proposed Revenue Procedure

REVENUE PROCEDURE 2002-

1. Purpose

This revenue procedure provides safe harbors for purposes of applying the nonrecognition rules of Section 1031 of the Internal Revenue Code (the "Code") to a like-kind exchange program involving ongoing, deferred exchanges of tangible personal property using a single intermediary (an "LKE Program").

2. Background

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

business or for investment.

.02 Section 1031(a)(3) of the Code provides that property received by the taxpayer (“replacement property”) is not treated as like-kind property if it (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) for the transfer’s federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Treas. Reg. § 1.1031(k)-1(c)(1) provides that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

.04 Treas. Reg. § 1.1031(k)-1(f) provides that, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property.

.05 Treas. Reg. § 1.1031(k)-1(g) sets forth safe harbor involving a qualified escrow account, a qualified trust, or a qualified intermediary, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of Section 1031 and the regulations. In each case, application of the safe harbor requires that (1) the escrow agent, trustee, or intermediary must not be a “disqualified person” as defined in Treas. Reg. § 1.1031(k)-1(k), and (2) the taxpayer’s agreement with the escrow agent, trustee or intermediary must expressly limit the taxpayer’s rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held in the qualified escrow or trust or by the qualified intermediary as provided in Treas. Reg. § 1.1031(k)-1(g)(6).

06. Treas. Reg. § 1.1031(k)-1(g)(4) requires that, for an intermediary to be a qualified

intermediary, the intermediary must enter into a written “exchange” agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer. The intermediary will be treated as acquiring or transferring property, as the case may be, if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement for the acquisition or transfer of property and, pursuant to that agreement, the property is transferred. Treas. Reg. § 1.1031(k)-1(g)(4)(iv). An intermediary will be treated as entering into an agreement for the acquisition or transfer of property if the taxpayer’s rights in the agreement are assigned to the intermediary, and the other parties to the acquisition or transfer agreement are notified in writing of the assignment on or before the date of the relevant transfer of property (the “Assignment Safe Harbor”). Treas. Reg. § 1.1031(k)-1(g)(4)(v). Under the Assignment Safe Harbor, the taxpayer is required to assign its rights arising

under the purchase of sale agreement; there is no requirement that the taxpayer also assign or delegate its obligations arising under the agreement.

.07 Although each LKE Program varies, LKE Programs typically have some or all of the following characteristics:

- (1) the taxpayer regularly and routinely enters into agreements to sell tangible personal property and agreements to buy tangible personal property;
- (2) the taxpayer uses a single, unrelated intermediary to accomplish the exchanges;
- (3) the taxpayer and the intermediary enter into a written exchange agreement (the “master exchange agreement”);
- (4) the master exchange agreement expressly limits the taxpayer’s rights to receive, pledge, or borrow or otherwise obtain the benefits of money or other property held by the intermediary as

provided in Treas. Reg. § 1.1031(k)-1(g)(6);

(5) in the master exchange agreement, the taxpayer assigns to the intermediary the taxpayer's rights (but not its obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property;

(6) the taxpayer provides written notice of the assignment to the other party to each existing and future agreement to sell relinquished property and/or to purchase replacement property;

(7) pursuant to those existing and future agreements, the relinquished properties are transferred directly from the taxpayer to the purchasers of the properties and the replacement properties are transferred directly to the taxpayer from the sellers of the properties;

(8) the taxpayer a) has put in place a process for identifying potential replacement property or properties before the end of the identification period for the relinquished property or group of relinquished properties of which it is disposing in each exchange, b) complies with the identification requirement by receiving replacement property or properties before the end of the 45-day identification period, or c) uses a combination of a) and b);

(9) the taxpayer has put in place a process for collecting, holding and disbursing funds (which may include the use of joint taxpayer and intermediary bank accounts, or accounts in the name of a third party for the benefit of both the taxpayer and the intermediary) that ensures that the intermediary controls the receipt, holding and disbursement of all funds to which the intermediary is entitled (i.e., proceeds from the sale of relinquished properties);

(10) relinquished property or properties that were transferred are matched with replacement property or properties that were received in order to determine the gain, if any, recognized on the disposition of the relinquished property and to determine the basis of the replacement property;

(11) the taxpayer recognizes gain or loss on the disposition of relinquished properties that are not matched with replacement properties, and the taxpayer takes a cost basis in replacement properties that are received but not matched with relinquished properties; and

(12) the taxpayer may provide various financial services in the ordinary course of its business to purchasers of relinquished property and sellers of replacement property at market terms.

.08 Treasury and the Internal Revenue Service have determined that it is in the best interest of sound tax administration to provide taxpayers with clear guidance regarding the qualification of LKE Programs under section 1031. Accordingly, this revenue procedure provides safe harbors that clarify the application of section 1031 and the regulations under section 1031 to LKE Programs.

3. Scope

.01 Exclusivity. This revenue procedure provides safe harbors for the qualification under section 1031 of exchanges of property. These safe harbors apply only in the limited contexts described in this revenue procedure. The principles set forth in this revenue procedure have no application to any federal income tax determination other than determinations that involve exchanges qualifying for nonrecognition of gain or loss under section 1031.

.02 No Inference. The Internal Revenue Service recognizes that exchanges of property can be accomplished outside the safe harbors provided in this revenue procedure. No inference is intended with respect to the federal income tax treatment of transfers of relinquished property and acquisitions of replacement property that do not satisfy the terms of the safe harbors provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.

.03 Effect of Failure to Satisfy the Requirements of a Safe Harbor. If the requirements of any safe

harbor in this revenue procedure are not satisfied, the determination of whether the taxpayer has satisfied the requirements of section 1031 and the regulations thereunder is to be made without regard to the provisions in this revenue procedure relating to that safe harbor.

4. Exchanges of Relinquished Property and Replacement Property

.01 In the case of an LKE Program, the taxpayer's transfer of each relinquished property or group of relinquished properties and the taxpayer's corresponding receipt of each replacement property or group of replacement properties with which the relinquished property or group of relinquished properties has been matched by the taxpayer will be treated as a separate and distinct exchange for purposes of section 1031. The determination of whether a particular exchange qualifies under section 1031 or this revenue procedure will be made without regard to any other exchange. Thus, if a particular exchange of a relinquished property or group of relinquished properties for a replacement property or group of replacement properties pursuant to an LKE Program fails to qualify under section 1031 or this revenue procedure, such failure will not affect the application of section 1031 or this revenue procedure to any other exchange pursuant to the LKE Program.

.02 The fact that replacement property received within the 45-day identification period is not matched with relinquished property until after the end of the 45-day identification period will not result in the transfer and receipt of the properties failing to qualify as an exchange.

5. Actual or Constructive Receipt of Money or Other Property

.01 Receipt of Checks and Other Negotiable Instruments. A taxpayer engaged in an LKE Program will not be considered in actual or constructive receipt of money or other property as a result of processing a check or other negotiable instrument made payable to a person other than the taxpayer if –

(A) The check or other negotiable instrument has not been endorsed by the person to whom the

check or other negotiable instrument is made payable;

(B) The person to whom the check or other negotiable instrument is made payable is not a disqualified person as defined in Treas. Reg. §1.1031(k)-1(k); and

(C) The check or other negotiable instrument is forwarded to or for the benefit of a qualified intermediary or deposited into an account in the name of the qualified intermediary, a joint account, or an account in the name of a third party for the benefit of both the taxpayer and the qualified intermediary.

.02 Joint Accounts. A taxpayer engaged in an LKE Program will not be considered in actual or constructive receipt of money or other property deposited into or held in a joint bank, trust, escrow or similar account in the name of the taxpayer and the qualified intermediary, or in an account in the name of a third party for the benefit of both the taxpayer and the qualified intermediary, if –

(A) The account is used to collect, hold and/or disburse proceeds arising from the sale of relinquished property and other funds;

(B) The agreement setting forth the terms and conditions with respect to the account requires authorization from the qualified intermediary to transfer proceeds from the sale of relinquished properties; and

(C) The agreement setting forth the terms of the taxpayer's and intermediary's rights with respect to, or beneficial interest in, the account otherwise expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of proceeds from the sale of relinquished property held in the joint account as provided in Treas. Reg. §1.1031(k)-1(g)(6).

.03 Taxpayer As Lender to Purchaser. If a taxpayer that is engaged in an LKE Program lends

money to the buyer for the purchase of the taxpayer's relinquished property, the taxpayer's receipt of the buyer's promissory note or other evidence of indebtedness will not be considered actual or constructive receipt of money or other property if –

(A) The taxpayer makes similar loans in the ordinary course of its business operations;

(B) The buyer is not obligated to obtain financing from the taxpayer for the purchase of the relinquished property, but rather is free to borrow the funds from another lender;

(C) The taxpayer's loan to the buyer is an arm's-length transaction at then prevailing market terms; and

(D) As required by the master exchange agreement, the taxpayer promptly transfers funds equal to the loan proceeds to or for the benefit of the qualified intermediary.

.04 Application of Lease Security Deposit To Purchase Price. In the case of a taxpayer that engages in an LKE Program and is the lessor of the property being purchased by the buyer-lessee, the buyer-lessee's application of its lease security deposit to the purchase price of the relinquished property will not be considered actual or constructive receipt of money or other property provided that, as required by the master exchange agreement, the taxpayer promptly transfers funds equal to the lease security deposit to or for the benefit of the qualified intermediary.

6. Definition of Qualified Intermediary

.01 An intermediary will not fail to be a qualified intermediary merely because the intermediary, in the context of an LKE Program –

(A) is assigned the taxpayer's rights in its agreements to sell relinquished properties that ultimately are not matched with replacement properties under the taxpayer's LKE Program;

(B) is assigned the taxpayer's rights in its agreements to buy replacement properties that ultimately are not matched with relinquished properties under the taxpayer's LKE Program;

(C) receives funds with respect to the transfer of relinquished property that is not matched with replacement property under the taxpayer's LKE Program; or

(D) pays funds with respect to the acquisition of replacement property that is not matched with relinquished property under the taxpayer's LKE Program.

.02 The taxpayer's assignment in the master exchange agreement to the intermediary of the taxpayer's rights (but not its obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property will be effective to satisfy the Assignment Safe Harbor.

7. Effective Date

This revenue procedure is effective on or after [the date this revenue procedure is published in the Internal Revenue Bulletin].

9. Paperwork Reduction Act

10. Drafting Information

Model LKE Program

PLR 20010922 (November 29, 2000) involves a very interesting exchange program for equipment. The taxpayer (T) acquires and disposes of large volumes of equipment and entered into a master exchange agreement with a QI that is a third-party financial institution. The parent

of the QI and its affiliates provided routine financial services to T and its affiliates, including funds processing, lines of credit, lockbox services, counterparties in foreign exchange swaps and purchases of taxpayer-issued debt obligations. These services were viewed as routine and QI was not deemed to be a disqualified person. The ruling illustrates a very clever mass exchange program that was held to meet the requirements of the safe harbors of the deferred exchange regulations. Within the 45-day identification period, old and new equipment were matched (apparently by computer program using certain parameters) to minimize boot and create a separate and distinct like-kind exchange for each match.

T and QI used the “assignment and notice” method of having QI acquire and transfer the relinquished and replacement property under Treas. Reg. Section 1.1031(k)-1(g)(4)(v). Under the master exchange agreement, T assigned its rights (but not its obligations) with respect to the sale of all equipment on the date the agreement was signed as well as equipment acquired by T in the future. Similarly, T assigned to QI its rights to purchase new equipment, including equipment acquired after the agreement was signed. In addition to these assignments of future equipment, T notifies QI of individual transactions by sending QI a report containing a listing of daily acquisitions and dispositions of equipment. The reports provide QI with a list of each transaction with respect to which QI has been assigned T’s rights.

T provides notice to purchasers of the relinquished property and sellers of the replacement property in two different ways. First, T sent a blanket notice to the other parties prior to the start of the like-kind exchange program. Second, T provides a purchaser or seller with a written notice in connection with each disposition of a relinquished property and each acquisition of a replacement property on or before the date of each transaction. The Service held that this system satisfied the “assignment and notice” method of having the QI acquire and transfer the properties.

Information about the old and new equipment is analyzed in T’s like-kind exchange matching system, and relinquished property is matched to replacement property according to certain parameters. Properties are matched only if the replacement property is acquired within 45

days after the transfer of the relinquished property to the purchaser. Further, to the extent possible, relinquished property is always matched with replacement property whose cost equals or exceeds the proceeds from the sale of the relinquished property. Where this is not possible, the matching system is designed to group property so that any excess of proceeds over costs (i.e., boot) is minimized. The Service held that this matching program will create a separate and distinct like-kind exchange for each match of properties.

A system of collections is used that results in proceeds from the sale of relinquished property being used by QI to purchase replacement property. At no time will the proceeds be placed in an account over which T has the power to obtain the funds, directly or indirectly, without QI's consent. The replacement property is then purchased by QI using the sales proceeds one day after and no later than 45 days after the transfer of the related relinquished property. If the proceeds are insufficient, T transfers additional funds to cover the shortfall. Unspent proceeds remaining in the account are invested by QI in accordance with T's instructions. Any income earned is reported by T for tax purposes. See Treas. Reg. Section 1.1031(k)-1(h). These earnings on the unspent proceeds are used by QI to acquire replacement property in the future. T's rights with respect to the income are restricted in accordance with the (g)(6) limitations. Apparently, the QI or its affiliates also processed funds for non-like-kind exchange transactions. This processing was kept sufficiently separate from the exchange program so as to avoid any adverse impact.

The master exchange agreement addressed the cash flows in T's exchange program and expressly provided for the (g)(6) limitations. T identified replacement property solely by receiving it before the end of the 45-day identification period as provided in Treas. Reg. Section 1.1031(k)-1(c)(1). This system avoided the problem of sending a written identification notice specifying multiple or alternative properties to be acquired in the future and the associated matching complications. If no replacement property is received with respect to a particular relinquished property within the identification period, the agreement permits T to receive the related proceeds from the sale of that relinquished property after the end of the identification

period in accordance with Treas. Reg. Section 1.1031(k)-1(g)(6)(ii). In such a case, T recognizes all realized gain from the sale of that relinquished property. Similar provisions are contained in a bank account agreement, and the approval of QI is required for each transfer of funds.

The Service held that the agreements concerning the flow of funds restrict T's rights in accordance with the (g)(6) limitations. Further, T will not otherwise have constructive receipt of the proceeds from the sale of relinquished property. In each type of transaction, QI receives the full amount of proceeds from the sale of relinquished property, no funds can be used without QI's approval, and the agreements properly limit T's rights. Apparently, T receives other funds in separate and distinct arm's length transactions from the sale of the relinquished property, but this will not result in actual or constructive receipt of the sales proceeds. The IRS cited 124 Front Street v. Commissioner, 65 T.C. 6 (1975), acq. 1976-2 C.B. 2 (taxpayer received loan advance from transferee to acquire relinquished property and later exchanged the property). Thus, the IRS fully approved T's mass exchange program. PLR 200109022 provides a relatively simple, efficient and sophisticated model for an exchange program involving large volumes of equipment.

CONCLUSION

The rulings on LKE Programs and Rev. Proc. 2002-69 evidence a continuing trend toward administrative simplification by the IRS. PLR 200251008 shows the great latitude taxpayers are often given to effect exchanges under Section 1031. The ruling approves a reverse build-to-suit exchange where the replacement property involved a new 32-year sublease from a related party. But Wiechens and Rev. Rul. 2002-83 caution that not everything is permissible under Section 1031. Section 1031 does not allow every exchange of real property interests or every acquisition of like-kind property, particularly replacement property sold by a related party. Compared to banner years when major cases were decided, regulations were issued or new revenue procedures were published, it has been a relatively quiet year for Section 1031. With official recognition that like-kind exchanges are not per se abusive and their removal from the final tax shelter

regulations, we look forward to more peace and quiet.