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Third Party Communication: None
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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B04
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Date:
December 22, 2005

Trust =

S Corp =

Buyer =

A =

Dear :

This responds to your request for a private letter ruling dated May 6, 2005, regarding § 1031 of the Internal Revenue Code.

STATEMENT OF FACTS:

Trust and S Corp are related persons within the meaning of § 1031(f)(3). Trust owns Building 1 and S Corp owns Building 2. Trust has transferred Building 1, including land and improvements, the tangible personal property, leases and other assets associated with Building 1, to Buyer. Trust wants to defer the recognition of the gain on the transfer of Building 1. Therefore, Trust will acquire Building 2, including land and improvements, as one of its identified replacement properties in exchange for Building 1 in a transaction intended to qualify for nonrecognition treatment under § 1031. S Corp will also engage in an exchange of Building 2 for other like-kind property in a transaction intended to qualify for nonrecognition treatment under § 1031.

To facilitate their exchanges, Trust and S Corp will enter into exchange agreements with a qualified intermediary ("QI") described in § 1.1031(k)-1(g)(4). Pursuant to Trust's exchange agreement, QI will, for purposes of § 1031 and the regulations thereunder, be treated as the seller of Building 1 to Buyer. Moreover, QI will be treated as acquiring Building 2 from S Corp and transferring it to Trust in exchange for Building 1. Similarly, pursuant to S Corp's exchange agreement, QI will be treated as acquiring property to replace Building 2 ("S Corp's Replacement Property") and transferring it to S Corp in exchange for Building 2. S Corp's Replacement Property is, prior to its transfer to QI, owned by a party that is not related to either Trust or S Corp.

Once all the transactions are completed, Trust will own Building 2, S Corp will own S Corp's Replacement Property, and Buyer will own Building 1. Trust represents that it will not dispose of Building 2 within two (2) years of its receipt as replacement property. S Corp represents that it will not dispose of S Corp's Replacement Property received in exchange for Building 2 within two (2) years of its receipt as replacement property. For purposes of these representations, both taxpayers assert that the principles of § 1031(f)(2) apply. Trust and S Corp each seek a ruling regarding the application of § 1031(f) to their respective exchanges.

After Trust acquires Building 2, QI will still hold approximately $A of the proceeds of the sale of Building 1 to Buyer. Trust has designated and intends to acquire additional like-kind properties from unrelated third parties in the transaction that will qualify under § 1031. In the event that Trust is unable to acquire such like-kind property, these funds will be distributed by QI to Trust. Trust also requests a ruling that if it receives such cash proceeds, they will cause Trust to recognize gain on the transfer of Building 1 but not in excess of the amount of cash distributed outright to Trust from QI.

STATEMENT OF LAW:

Section 1031(a)(1) generally provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031(b) provides that if an exchange would be within § 1031(a)(1) but for the fact that cash or other non-like kind property is received in the exchange, gain is recognized but in an amount not in excess of the cash or other non-like kind property received in the exchange.

Section 1031(f) sets forth special rules for exchanges between related persons. Section 1031(f)(1) provides that if (A) a taxpayer exchanges property with a related person; (B) there is nonrecognition of gain or loss to the taxpayer in accordance with § 1031 with respect to the exchange; and (C) within 2 years of the date of the last transfer that was part of the exchange either the taxpayer or the related person disposes of the property received in the exchange, then there is no nonrecognition of gain or loss in the exchange. In other words, the gain or loss that was deferred under § 1031 must be recognized. Any gain or loss the taxpayer is required to recognize by reason of § 1031(f)(1) is taken into account as of the date of the disposition of the property received in the exchange (the second disposition).

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

Section 1031(f)(4) provides that § 1031 shall not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of § 1031(f). Thus, if a transaction is set up to avoid the restrictions on exchanges between related persons, § 1031(f)(4) operates to prevent nonrecognition of the gain or loss on the exchange.

In Rev. Rul. 2002-83, 2002-2 C.B. 927, a taxpayer transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party. As part of the transaction, the related party receives cash for the replacement property. The ruling holds that because the taxpayer's use of the qualified intermediary was to avoid the application of § 1031(f)(1), the taxpayer, under § 1031(f)(4), was not entitled to nonrecognition treatment under § 1031.

ANALYSIS:

In the present case, § 1031(f)(1) is not applicable to currently tax Trust's disposition of Building 1 because Trust is exchanging property with a qualified intermediary, who is not a related party. However, § 1031(f)(4) provides that § 1031 shall not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of § 1031(f). Thus, § 1031 will not apply if Trust's exchange is structured to avoid the "purposes" of § 1031(f). Both the Ways and Means Committee Report and the Senate Finance Committee Print describe the policy concern that led to enactment of this provision:

> Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The

> committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment.

H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989); S. Print No. 56, at 151. The Committee Reports also included the following example of when § 1031(f)(4) applies: 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. H.R. Rep. No. 247, at 1341; S. Print No. 56, at 152.

In Rev. Rul. 2002-83, the Service discussed and applied § 1031(f)(4) to the following facts:

> 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 § 1031(a). A and B are related persons within the meaning of § 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 transfers Property 1 to QI and QI transfers Property 1 to C for $150x. On January 13, 2003, QI acquires Property 2 from B, pays B the $150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

In analyzing these facts under § 1031(f)(4), the Service quoted the legislative history cited above for the proposition that § 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. In such case, the original exchange should not be accorded nonrecognition treatment. Under the facts in the revenue ruling, A and B were attempting to sell Property 1 to an unrelated party while using the substituted basis rule of § 1031(d) to reduce the gain on such sale from $100x to $0. This allowed the parties to "cash out" of their investment in Property 1 without the recognition of gain. The Service concluded that the transaction was structured to avoid the purposes of § 1031(f)(1) and, therefore, A had gain of $100x on its transfer of Property 1.

The legislative history underlying § 1031(f)(2)(C) provides that any second disposition by exchanging parties will not be taken into account for purposes of § 1031(f)(1) if it can be established to the satisfaction of the Secretary that neither the initial exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax. In that regard, the Conference Committee Report, which adopted the Senate amendment, noted that the Senate Finance Committee Report provided that "the non-tax avoidance exception generally will apply to ... dispositions in nonrecognition transactions ...." H.R. Rep. No. 386, 101st Cong., 1st Sess. 613 (1989).

In the present case, the only disposition contemplated by the parties after Trust receives Building 2 as replacement property is the acquisition by S Corp of S Corp's Replacement Property in another exchange under § 1031, a nonrecognition transaction. Thus, because S Corp is structuring its disposition of Building 2 as an exchange for like-kind replacement property so that the gain on the transfer of Building 2 is eligible for nonrecognition treatment under § 1031(a), § 1031(f)(4) and Rev. Rul. 2002-83 are not applicable. Trust's exchange and S Corp's exchange are structured as like-kind exchanges qualifying under § 1031. There is no "cashing out" of either party's investment in real estate. Upon completion of the series of transactions, both related parties will own property that is like-kind to the property they exchanged. Moreover, neither party will have ever been in receipt of cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property. Finally, under § 1031(b), any receipt of cash by Trust from QI will result in gain to Trust not in excess of the cash received.

Based on the facts and representations submitted by the taxpayer, we rule as follows:

1. Section 1031(f) will not apply to trigger recognition of any gain realized in Trust's exchange of Building 1 for Building 2 or S Corp's exchange of Building 2 for S Corp's Replacement Property, provided that Trust does not dispose of Building 2 within two (2) years of its receipt as replacement property and S Corp does not dispose of S Corp's Replacement Property received in exchange for Building 2 within two (2) years of its receipt as replacement property.

2. If Trust does not acquire replacement property in addition to Building 2 and receives a distribution of $A from QI, receipt of such cash will cause Trust to recognize gain on the Building 1 transaction, but not in excess of the $A distributed to it from QI.

DISCLAIMERS

These rulings relate only to the application of § 1031(f) to the exchanges described above. No opinion is expressed regarding whether the other requirements of § 1031 have been satisfied. Further, even if the other requirements of § 1031 are met, nonrecognition treatment does not apply to the extent of any boot in the form of cash or other nonlike-kind real, personal or intangible property received by Trust and S Corp in the exchanges at issue. See § 1031(b); and Rev. Rul. 67-255, 1967-2 C.B. 270. Finally, except as specifically provided above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under § 6110. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Michael J. Montemurro
Branch Chief
(Income Tax & Accounting)

cc: