Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:IT&A:5
PLR-126651-06

Date:
November 20, 2006

In Re:

LEGEND:

Taxpayer =

Taxpayer's Address =

Taxpayer's ID =

Related Party =

Limited Liability Co. =

$A =

$B =

D Corp. =

E Corp. =

F Corp. =

Relinquished Property =

Replacement Property =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear :

This letter responds to your ruling request submitted on behalf of Taxpayer by letter dated May 22, 2006 as to whether nonrecognition treatment under § 1031(a) of the Internal Revenue Code will apply to its transfer of real property in a multi-party exchange involving a related party and a qualified intermediary.

STATEMENT OF FACTS

We rely on the facts and conditions set forth in Taxpayer's submissions dated May 22, 2006.

Taxpayer and Related Party are related persons within the meaning of § 1031(f)(3). Taxpayer acquired Relinquished Property on Date 1 and held it as rental property. In Taxpayer's possession, Relinquished Property's fair market value substantially increased.

Related Party wished to acquire Relinquished Property from Taxpayer, and Taxpayer wished to transfer Relinquished Property to Related Party through a like-kind exchange pursuant to § 1031. However, because Related Party did not own like-kind assets that Taxpayer wished to acquire, Taxpayer entered into an agreement with an unrelated third party to acquire Replacement Property. Replacement property is like-kind to Relinquished Property within the meaning of § 1031(a) and § 1.1031(a)-1(b). Replacement Property's fair market value was substantially higher than Relinquished Property's fair market value. The unrelated third party required the closing of the sale of Replacement Property to occur before Taxpayer transferred Relinquished Property to Related Party, and accordingly, Taxpayer structured the transaction as a "reverse" like-kind exchange under the provisions of Rev. Proc. 2000-37, 2002-2 C.B. 308, modified by Rev. Proc. 2004-51, 2004-2 C.B. 294.

On Date 2, Taxpayer and E Corp. entered into a qualified exchange accommodation arrangement described in Rev. Proc. 2000-37. E Corp. is a domestic single-owner limited liability company and wholly owned by D Corp. E Corp. is disregarded as a separate taxpayer pursuant to § 301.7701-3(b)(1)(ii) and has never made nor intends to make an election under § 301.7701-3(c)(1) to be taxed as an

association. D Corp. and E Corp. are unrelated to Taxpayer and Related Party. In this reverse like-kind exchange, E Corp. functioned as an exchange accommodation titleholder ("EAT").

In addition, on the same day, Taxpayer loaned to E Corp. $A, which is equal to the purchase price of Replacement Property, and D Corp. granted Taxpayer a security interest in 100-percent of the membership interest in E Corp. as collateral for Taxpayer's loan to E Corp. E Corp. purchased the Replacement Property for $A on Date 3.

On Date 4, Taxpayer entered into an agreement with Related Party to transfer Relinquished Property to Related Party's wholly owned subsidiary, Limited Liability Co. Concurrently, Taxpayer and F Corp., which is an affiliate of D Corp., entered into an agreement to assign Taxpayer's right to receive Relinquished Property sales proceeds, $B, to F Corp. F Corp. is a qualified intermediary ("QI") described in § 1.1031(k)-1(g)(4), and not a "disqualified person" with respect to Taxpayer within the meaning of § 1.1031(k)-1(k). Pursuant to the agreements, Taxpayer transferred Relinquished Property to Limited Liability Co., and Limited Liability Co. paid $B to F Corp.

To complete the exchange, Taxpayer instructed F Corp. to acquire Replacement Property. Accordingly, F Corp. purchased 100-percent of the membership interest in E Corp. from D Corp., subject to E Corp.'s obligation under the loan, for $B. At F Corp.'s direction, D Corp. transferred the E Corp.'s membership interest to Taxpayer and also transferred $B to Taxpayer to pay down the loan. Because E is a disregarded entity for federal tax purposes, a transfer of all the interest in E Corp. is treated as a transfer of the assets of E Corp. As a result, the outstanding balance of the loan was cancelled because Taxpayer in effect became both the debtor and the creditor with respect to such balance.

After the above-transactions, Taxpayer held Replacement Property and Related Party held Relinquished Property. Related Party intends to dispose Relinquished Property within two years of its receipt.

LAW AND ANALYSIS

Applicable Requirements for Deferral under § 1031.

Section 1031 was initially promulgated to avoid taxing gains that were mere "paper profits," *i.e.*, the taxpayer had realized nothing tangible and to tax them seriously interfered with normal business adjustments. Revenue Act of 1934, Sec. 112.

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.

In arranging the like-kind exchange, § 1.1031(k)-1(g)(4) allows taxpayers to use a QI to facilitate a like-kind exchange. A taxpayer's transfer of relinquished property to a QI and subsequent receipt of like-kind replacement property from the QI is treated as an exchange with the QI.

Section 1031(f) was subsequently enacted to accord nonrecognition treatment only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment. 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 would not be accorded nonrecognition treatment. *See* H.R. REP. NO. 101-247, at 1341 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2811.

Section 1031(f)(1) sets forth special rules for exchanges between related persons. Section 1031(f)(1) provides that if (1) a taxpayer exchanges property with a related person, (2) nonrecognition treatment is offered to the taxpayer in accordance with § 1031 with respect to the exchange, and (3) within two years of the date of the last transfer either the taxpayer or the related person disposes of the property received in the exchange, then there is no nonrecognition of gain or loss in the exchange. In other words, the gain or loss that was deferred under § 1031 must be recognized as of the date of the disposition of the property received in the exchange.

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of § 1031(f)(1). These include any disposition (1) after the earlier of the death of the taxpayer or the death of the related person, (2) in a compulsory or involuntary conversion (within the meaning of § 1033) if the exchange occurred before the threat or imminence of such conversion, or (3) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such 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 of § 1031(f), § 1031(f)(4) operates to prevent nonrecognition of the gain or loss in the exchange.

Both the Ways and Means Committee Report and the Senate Finance Committee Print describe the policy concern that led to enactment of § 1031(f)(4):

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

H.R. REP. NO. 101-247, at 1340-41 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2810-11.

The Parking Transaction under Rev. Proc. 2000-37.

Rev. Proc. 2000-37 sets forth a safe harbor for acquiring replacement property under a qualified exchange accommodation arrangement ("QEAA"), sometimes referred to as a "parking" transaction, to facilitate reverse like-kind exchanges. As provided in this safe harbor, the Service will not challenge either (1) the qualification of property as either replacement or relinquished property (as defined in § 1.1031(k)-1(a)), or (2) the treatment of the EAT as the beneficial owner of such property for Federal income tax purposes, if the property is held in a QEAA as defined in section 4.02 of Rev. Proc. 2000-37.

APPLICATION AND ANALYSIS

Taxpayer represents that the exchange satisfies the requirements for deferred exchanges set forth in § 1.1031(k)-1 and the safe harbor for reverse exchanges set forth in Rev. Proc. 2000-37. Accordingly, the only issue in this case is whether non-recognition treatment under § 1031 would apply to a transaction where (1) Taxpayer purchases like-kind Replacement Property from an unrelated third party via EAT, (2) Taxpayer sells Relinquished Property to Related Party for cash consideration received by a QI, and (3) Related Party disposes Relinquished Property within two years of the acquisition.

Related Party's disposal of Relinquished Property within two years of the acquisition will not trigger taxable gains pursuant to § 1031(f)(1). In the instant case, Taxpayer and Related Party did not engage in a like-kind exchange. Taxpayer transferred Relinquished Property to Related Party through a QI, who also purchased Replacement Property from an unrelated third person for Taxpayer. Taxpayer's transfer of Relinquished Property to the QI and subsequent receipt of like-kind Replacement Property from the QI is treated as an exchange with the QI, who is not related to Taxpayer. Treas. Reg. § 1.1031(k)-1(g)(4).

In addition, § 1031(f)(4) will not apply to prevent nonrecognition of the gain or loss in the exchange. Taxpayer did not transfer Relinquished Property to Related Party as part of a transaction or series of transactions, structured to avoid the purposes of § 1031(f)(1). The related parties in this case did not exchange high basis property for low basis property in anticipation of the sale of the low basis property. Only Taxpayer held property before the reverse like-kind exchange and continued to hold like-kind property after the exchange. Related Party did not hold property before the exchange. Accordingly, Related Party's proposed disposal of Relinquished Property within two years of the acquisition will not result in a "cashing out" of an investment or shifting of basis between Taxpayer and Related Party.

RULING

Under the given facts and representations, § 1031(f) will not apply to trigger recognition of any gain realized when (1) Taxpayer purchases like-kind Replacement Property from an unrelated third party via EAT, (2) Taxpayer sells Relinquished Property to Related Party for cash consideration received by a QI, and (3) Related Party disposes Relinquished Property within two years of the acquisition.

DISCLAIMERS

Except as 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. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, nor effects resulting from, the transaction that are not specifically covered by the above ruling.

This ruling assumes that (1) E Corp. is eligible to serve as EAT within the meaning of Rev. Proc. 2000-37, (2) F Corp. is eligible to serve as QI in this transaction within the meaning of § 1.1031(k)-1(g)(4), (3) Taxpayer and Related Party are related persons within the meaning of § 1031(f)(3), and (4) the transaction satisfies the requirements for deferred exchanges set forth in § 1.1031(k)-1 and the safe harbor for reverse exchanges set forth in Rev. Proc. 2000-37. While this office has not verified

any of the material submitted in support of the request for ruling, it is subject to verification on examination. No opinion is expressed as to whether the accommodators used in this transaction are disqualified persons as defined in § 1.1031(k)-1(k), as that would constitute essentially a factual determination.

This ruling is directed only to Taxpayer. Section 6110 (k)(3) provides that it may not be cited as precedent. Pursuant to the Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representatives.

Sincerely,

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William A. Jackson
Branch Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax and Accounting)