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Department of the Treasury

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Third Party Communication: None

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PLR-134997-06

Date:

November 28, 2006

LEGEND

Taxpayer =

State A =

Parent REIT =

State B =

Date C =

Operating Partnership =

Property D LLC =

Property D =

Dear :

This responds to your request for a private letter ruling dated July 19, 2006, regarding § 1031 of the Internal Revenue Code.

FACTS

Taxpayer is a State A limited liability company (LLC) that is taxed as a partnership. Taxpayer is an affiliate of Parent REIT, a publicly held real estate investment trust (REIT) organized in State B that elected to be taxed as a REIT beginning with its taxable year ended on Date C.

Parent REIT is the sole general partner and 90 percent owner of Operating Partnership, a State A limited partnership that is classified as a partnership for federal income tax purposes. Operating Partnership owns a 99 percent interest in Taxpayer and is the managing member. Operating Partnership also is sole owner of various entities that have each filed an election under § 856(l)(1) to be treated as a taxable REIT subsidiary of Taxpayer.

Taxpayer owns multiple parcels of real property through separate LLC's and partnerships. Taxpayer owns all of Property D LLC, a disregarded entity that owns Property D, an office and retail property. Taxpayer has owned and held Property D for more than two years in its business of leasing space to tenants.

Taxpayer proposes the following transaction:

- 1) Taxpayer will agree to transfer all its membership interest in Property D LLC to a taxable REIT subsidiary (Buyer TRS) for an amount of cash equal to its fair market value (Sale Agreement).
- 2) Taxpayer will enter into an agreement with an unrelated party to act as a qualified intermediary (QI) (as defined in § 1.1031(k)-1(g)(4) of the Income Tax Regulations) in the Taxpayer's exchange. The QI will not be a "disqualified person" with respect to Taxpayer within the meaning of § 1.1031(k)-1(k).
- 3) Taxpayer will assign to QI its rights to receive all proceeds payable by Buyer TRS in the Sales Agreement.
- 4) Buyer TRS will pay the price stated in the Sale Agreement to QI and Taxpayer will convey its interest in Property D LLC to Buyer TRS.
- 5) Taxpayer will identify a limited number of replacement properties to QI within 45 days after the transfer of its interest in Property D LLC to Buyer TRS in compliance with § 1.1031(k)-1(b) and (c).
- 6) Taxpayer will direct QI to acquire and transfer to Taxpayer one or more of the designated replacement properties within 180 days after Taxpayer's transfer of its interest in Property D LLC.

Buyer TRS anticipates selling some or all of the property it acquired from Taxpayer within two years from the date of its acquisition by Buyer TRS. Taxpayer and Buyer TRS are related within the meaning of § 1031(f)(3).

## 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(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)(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.

## ANALYSIS

In the present case, § 1031(f)(1) is not applicable to currently tax Taxpayer's disposition of Property D because Taxpayer is exchanging property with a QI that is not a related person.<sup>1</sup> 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 Taxpayer'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 §1031(f):

Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have

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<sup>1</sup> Although Taxpayer transferred its interest in Property D LLC, a disregarded entity, the sale of such interest is treated as a sale of the assets of the disregarded entity for federal income tax purposes. Rev. Rul. 99-5, 1999-1 C.B. 434.

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) and, therefore, A had gain of \$100x on its transfer of Property 1.

In the present case, Taxpayer and Buyer TRS are not exchanging properties either directly or through the QI. Buyer TRS did not own, prior to the exchange, any property that Taxpayer will acquire in the exchange. Rather, prior to the exchange, Taxpayer owns Property D and Buyer TRS, the related person, will acquire Property D by purchasing it for a fair market value price from the QI. Thus, because there is no transaction, or series of transactions, structured to avoid the purposes of § 1031(f), § 1031(f)(4) is not applicable. In addition, because § 1031(f)(1) and § 1031(f)(4) are not applicable, the restriction contained in § 1031(f)(1)(C) on disposition of the relinquished property or the replacement property within two years of acquisition does not apply.

#### RULING

Based on the facts and representations submitted by Taxpayer, we rule that § 1031(f) will not apply to trigger recognition of any gain realized when Taxpayer (i) transfers the relinquished property to Buyer TRS, a related person, for cash consideration received by the QI, (ii) acquires like-kind replacement property from an unrelated person through the QI, and (iii) Buyer TRS disposes of some or all of Taxpayer's relinquished property within two years of the acquisition.

#### 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. In addition, no opinion is expressed regarding whether Parent REIT qualifies as a REIT for federal income tax purposes. 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.

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

Sincerely,

Michael J. Montemurro  
Chief, Branch 4  
(Income Tax & Accounting)