**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

Number: **201013038**
Release Date: 4/2/2010

CC:ITA:B04:JPBaumgarten
POSTN-117919-08

UILC: 1031.02-00, 1031.05-00

date: January 28, 2010

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subject: Heavy Equipment Dealers: Like-kind Exchange Program

This memorandum responds to your April 15, 2008, request for advice.

ISSUE

Does the transaction described below constitute a like-kind exchange eligible for nonrecognition treatment under § 1031(a) of the Internal Revenue Code?

CONCLUSION

No. The transaction is structured to avoid the § 1031(f) restrictions on exchanges between related parties. The Taxpayer has not established that the transaction meets the § 1031(f)(2)(C) exception to the restrictions on exchanges between related parties.

FACTS

Dealer sells a certain type of equipment, its brand, at retail. Taxpayer leases that type of equipment to unrelated customers in the course of its trade or business. Despite dealing in the same brand of equipment, Taxpayer and Dealer organized as separate but related parties within the meaning of § 267(b) of the Code. Under a master exchange agreement described in Rev. Proc. 2003-39, 2003-1 C.B. 971, Taxpayer uses a qualified intermediary (QI) to exchange its old equipment for new equipment. QI is not related to either Taxpayer or Dealer within the meaning of § 267(b).

The following is a representative transaction. Taxpayer owned an Old Off-Road Truck (relinquished property or RQ) with a fair market value of $750,000 and an adjusted basis of $150,000. Dealer owned a New Off-Road Truck (replacement property or RP) with a fair market value of $760,000 and an adjusted basis of $760,000. Taxpayer held RQ for use in its leasing trade or business within the meaning of § 1031(a), and Dealer held RP for (retail) sale.

Taxpayer entered into a standard sales contract to sell RQ to C, an individual unrelated to Taxpayer and Dealer. Taxpayer then assigned to QI all of Taxpayer's rights in and to the sales contract.[1] Pursuant to the master exchange agreement, on June 30, Year 1, Taxpayer transferred RQ to QI and QI sold RQ to C for $750,000. On August 13, Year 1, Taxpayer identified RP, which was part of Dealer's inventory. On September 10, Year 1, QI bought RP from Dealer for $760,000. QI used the $750,000 proceeds from the sale of RQ, plus $10,000 from other sources, to buy RP from Dealer. QI then transferred RP to Taxpayer.

Taxpayer acknowledges that it could have obtained RP directly from the unrelated manufacturer of RP or an unrelated dealer. Taxpayer represents that it has independent business reasons for always acquiring its replacement property from Dealer. Taxpayer states that it benefits from the proximity of Dealer's inventory to Taxpayer's business and the stability of supply due to the good will and established business relations between Dealer and the manufacturer. In addition, the manufacturer provides incentives to Dealer for each unit of equipment that Dealer sells.

ANALYSIS

Applicable Law

Section 1031(a)(1) 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. We refer to this as § 1031(a) nonrecognition treatment.

Section 1031(f) limits nonrecognition treatment for property exchanges between related parties. Section 1031(f)(1) generally denies § 1031(a) nonrecognition treatment if (A) a taxpayer exchanges property with a related person, (B) gain or loss to the taxpayer would not be recognized under § 1031 (determined without regard to § 1031(f)), and (C)

[1] For purposes of this memorandum we assume that Taxpayer meets the requirements in § 1031(a) and § 1.1031(k)-1(g) of the Income Tax Regulations concerning assignments of rights under sales and purchase agreements to the qualified intermediary, notices of assignments to all persons involved in those transfers, and the limitations in § 1.1031(k)-1(g)(6) on the use of the proceeds held by the qualified intermediary.

before the date 2 years after the date of the last transfer which was part of such exchange —

> (i) the related person disposes of such property, or
>
> (ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer.

The taxpayer takes into account any gain or loss recognized by reason of § 1031(f) as of the date on which the last disposition occurs.

Section 1031(f)(2) excepts certain related party exchanges from the § 1031(f)(1)(C) restriction on subsequent dispositions. Only the exception in § 1031(f)(2)(C) could be available to Taxpayer. Section 1031(f)(2)(C) provides that "there shall not be taken into account any disposition 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) denies § 1031(a) nonrecognition treatment for any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of the related party exchange restrictions contained in § 1031(f).

Related Party Exchange Restrictions

The §1031(f) restrictions are designed to prevent nonrecognition treatment for any transaction that is the economic equivalent of a § 1031(f)(1) related party exchange followed by a §1031(f)(1)(C) disposition of one of the exchanged properties, even if the transaction is structured as a like-kind exchange through a QI. Section 1031(f)(4) was enacted specifically to preclude § 1031(a) nonrecognition treatment for any exchange that is part of a transaction, or series of transactions, structured to avoid the related party transaction rules of § 1031(f). Both the Ways and Means Committee Report and the Finance Committee Print describe the policy concern that led to the 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 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 the 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 include the following example of when § 1031(f)(4) applies:

> If a [related party], pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a [taxpayer intending to defer gain under § 1031] within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the [taxpayer] will not be entitled to nonrecognition treatment under section 1031.

S. Print. No. 56, at 152.

Section 1031(f)(4), Structured Avoidance

Taxpayer structured its transaction to achieve the impermissible result that Congress addressed in the legislative history. The transaction is the economic equivalent of a related party exchange described in § 1031(f)(1). Taxpayer interposed QI to accomplish what §1031(f)(1) would prevent, *i.e.*, (1) the related party group (Taxpayer and Dealer) begins with two properties (RQ and RP) and, following a series of transactions, owns just RP and receives cash for RQ; and (2) Taxpayer avoids recognizing gain on the exchange of low-basis RQ for RP while Dealer realizes little or no gain on its taxable sale of high-basis RP.

Rev. Rul. 2002-83, 2002-2 C.B. 927, illustrates the rule that taxpayers may not avoid the § 1031(f) related party restrictions by structuring transactions through unrelated parties. The facts are almost identical to this case. Individual A owned Property 1 with a fair market value of $150x and an adjusted basis of $50x. Individual B owned Property 2 with a fair market value of $150x and an adjusted basis of $150x. A and B are related parties within the meaning of § 267(b). C, an unrelated party, wanted to acquire Property 1. Instead of selling Property 1 directly to C or selling the property to C after a § 1031(f)(1) related party exchange (between A and B), A transferred Property 1 to QI which sold Property 1 to C. QI then bought Property 2 from B with the proceeds of the sale of Property 1 and transferred Property 2 to A. A reported the transaction as a like-kind exchange of Property 1 for Property 2, even though B never received Property 1. (C bought and received Property 1.) B reported $0 gain because B's adjusted basis ($150x) in Property 2 was equal to the amount B realized on its sale.

Rev. Rul. 2002-83 recognized that the end result of the transaction was the same as if A and B had exchanged Property 1 and Property 2 then B sold Property 1 to C. Before the transaction, the related parties owned two properties and, in the transaction, "cashed out" of one of the properties contrary to the policy of § 1031(f). Therefore, A's exchange of property with QI was part of a transaction structured to avoid the § 1031(f) restriction on exchanges between related parties. Section § 1031(f)(4) operates to deny § 1031(a) nonrecognition treatment for a transaction "structured to avoid the purposes of this subsection [§ 1031(f)]." Similar to the situation in Rev. Rul. 2002-83, Taxpayer and Dealer attempted to exchange RQ and RP then "cash out" of RQ.

In *Teruya Brothers Ltd. & Subsidiaries v. Commissioner,* 124 T.C. 45 (2005), *aff'd,* 580 F.3d 1038 (9th Cir. 2009), the petitioner entered into two different transactions for the sale of real estate. In each instance, the purchaser of petitioner's property was an unrelated party. In attempting to structure the transactions as exchanges under § 1031, the petitioner used a qualified intermediary to transfer its real estate to the unrelated party and acquire like-kind properties owned by a related party, Times Super Market, Ltd. (Times). The petitioner intended to gain a significant tax advantage by structuring the transactions as exchanges with a qualified intermediary rather than as taxable sales or direct exchanges with the related party followed by sales of the relinquished property to the unrelated party. The court held that the exchanges were transactions (or series of transactions) structured to avoid the § 1031(f) restrictions on exchanges between related parties. The court explained:

> These transactions are economically equivalent to direct exchanges of properties between Teruya and Times (with boot from Teruya to Times), followed by Times's sale of properties to unrelated third parties. The interposition of a qualified intermediary cannot obscure the end result. . . . Under the circumstances, we are led to the conclusion that Teruya used the multiparty structures to avoid the consequences of economically equivalent direct exchanges with Times. *Id.* at 53.

*See also Ocmulgee Fields, Inc. v. Commissioner*, 132 T.C. No. 6 (2009), which concludes that § 1031(f)(4) applies where the only property identified (and subsequently acquired) by the taxpayer as its replacement property was property owned by a related party.

Section 1031(f)(2)(C) Exception

Section 1031(f)(2)(C) provides that subsequent dispositions under § 1031(f)(1)(C) will be disregarded (not taken into account) if "…it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as *one of its principal purposes* [emphasis added] the avoidance of Federal income tax." Taxpayer cites a number of independent business (nontax) reasons for exchanging RQ for RP through a QI facilitated like-kind exchange. Taxpayer asserts that it acquired RP from Dealer for valid business reasons, *e.g.*, Dealer receives incentives from the manufacturer for all sales, and Taxpayer patronized Dealer (a related party) rather than the manufacturer or another dealer to obtain the incentives for Dealer. Taxpayer also cites convenience, good will, established customer relationship, and the possibility of financing discounts as other business considerations for patronizing Dealer.

However, the question is whether the existence of these business considerations establishes that tax avoidance was not one of Taxpayer's principal purposes for structuring the transaction as a like-kind exchange. The legislative history is instructive.

The Senate Finance Committee listed three instances in which the non-tax avoidance exception in § 1031(f)(2)(C) should apply:

> It is intended that the non-tax avoidance exception generally will apply to (i) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties; (ii) dispositions of property in nonrecognition transactions; and (iii) transactions that do not involve the shifting of basis between properties.

H.R. Rep. No. 247, at 1341; S. Print. No. 56, at 152.

The Taxpayer's transactions are neither exchanges of undivided interests nor dispositions of property in a nonrecognition transaction by one of the related parties. However, the exchange here clearly results in basis shifting: Dealer is selling inventory into the exchange at its cost (realizing no gains), while Taxpayer is attempting to defer its gain from the disposition of RQ under § 1031(a) by taking a substituted basis (the high basis of RP for the low basis of RQ). Congress considered transactions (like the exchange here) that involve basis shifting, followed by a cashing out of the high-basis property, as ineligible for the § 1031(f)(2)(C) exception.

As a matter of interpretation, the Service has consistently limited the § 1031(f)(2)(C) exception to the situations that Congress so specifically described in the legislative history. See Rev. Rul. 2002-83. We are not willing to expand the exception to cover Taxpayer's situation.

Taxpayer cites its independent business reasons for structuring the transactions as evidence that tax avoidance was not its *sole* objective. However, § 1031(f)(2)(C) excepts transactions only if *none* of the principal purposes for the structure is tax avoidance. Even though Taxpayer may have had some non-tax-avoidance (independent business) reasons for structuring the exchange, it is clear that immediate tax reduction (through deferral) was also one of Taxpayer's principal objectives. Consequently, the § 1031(f)(2)(C) exception does not apply.

Taxpayer could have directly exchanged RQ for RP with Dealer which could then sell RQ to C. That disposition (*i.e.*, the "cashing out" of RQ), would have triggered § 1031(f)(1) and gain recognition on the disposition of RQ. Instead, Taxpayer attempted to characterize the disposition of RQ as part of a § 1031 like-kind exchange through QI to avoid recognition of gain on the disposition of RQ. The transactions result in the type of basis-shifting between related parties that § 1031(f) is meant to prevent.

Accordingly, Taxpayer must recognize the gain realized on the sale of RQ through QI to C.

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