OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT:
Like Kind Exchange between Parent and Subsidiary

This Field Service Advice responds to your request dated January 13, 1999, wherein you asked that we reconsider aspects of our earlier advice of November 25, 1996, regarding the subject taxpayer. This Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document may not be cited as precedent.

LEGEND:

Taxpayer	=
Corp. A	=
X	=
Y	=
Equipment	=
Year 1	=

ISSUE:

Whether the Service can take the position that an exchange of certain equipment among corporations within Taxpayer's consolidated group does not qualify as a tax-free exchange under I.R.C. § 1031.

CONCLUSION:

The Service could correctly, as a matter of law and policy, challenge nonrecognition treatment here and assert that the transactions involved do not qualify under section 1031.

FACTS:

Taxpayer owns, operates, leases and sells Equipment and Equipment parts. In Year 1, Taxpayer and Corp. A entered into an agreement for the sale of Y used Equipment. The transfer of X of that used Equipment is in issue here.

Taxpayer's basis in the Equipment had been substantially reduced by depreciation over the years by the time it had agreed to sell the used Equipment to Corp. A. Thus, purportedly, in order to avoid a large gain on the sale of this Equipment, Taxpayer entered into "tax-free" exchange agreements with two of its subsidiaries whereby the used Equipment of Taxpayer was swapped for certain new Equipment recently purchased directly by the subsidiaries from an individual shareholder.

The new Equipment had a relatively high basis compared to the long-depreciated basis of the old Equipment. The subsidiaries then transferred the Equipment to Corp. A to satisfy Taxpayer's obligation under the sales agreement with Corp A. The subsidiaries apparently recognized and reported the minimal gain made on the transfer to Corp. A of the old Equipment (which now carried a much higher basis in the hands of the subsidiaries). If allowed, therefore, the transaction enabled Taxpayer to avoid the large gain inherent in a direct sale of its used Equipment as well as to escape any required recapture of depreciation taken on that Equipment.

LAW AND ANALYSIS:

Section 1031(a) 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 a like kind which is also to be held for productive use in a trade or business or for investment. The "touchstone" of section 1031 is the requirement that "there be an exchange of like-kind properties rather than a cash sale" and reinvestment of proceeds. Young v. Commissioner, T.C. Memo. 1985-221.

An exchange is not limited to reciprocal transfers between two parties. Multiple-party and "accommodating" party exchanges are certainly allowed.[1] Where a party acts as a mere conduit or agent for the taxpayer, however, the exchange is not cognizable under section 1031. Coupe v. Commissioner, 52 T.C. 394, at 406 (1969). Similarly, passing the property to a "sham" or "strawman" also fails the test. See Garcia v. Commissioner, 80 T.C. 491, at 500-01 (1983).

As we discussed in our earlier memorandum, Congress has recognized the inherent tax-avoidance motivations of exactly the type of transaction presented here. It passed section 1031(f) to end those possibilities by requiring a longer holding period for the related party swap to be allowed nonrecognition. Section 1031(f), however, was not in effect for the year in issue; consequently, it is unavailable to challenge this deal. We note also that even under new section 1031(f), related party exchanges are not universally barred. Such swaps merely carry a longer holding requirement.

Where a wholly-owned subsidiary purchased new trucks from a manufacturer, while its parent sold its used trucks to the same manufacturer, the transaction was treated as merely a tax-free exchange between the related corporations and not as a separate sale and purchase. Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968). In Redwing Carriers, it was the Government successfully seeking to invoke section 1031 treatment. The swapping parties' interrelationship, however, was never made an issue.

There are numerous other instances where related parties attempting to effect a section 1031 transaction went unchallenged on that particular ground. See, e.g., Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir 1963); Rev. Rul. 72-151, 1972-1 C.B. 225 (sole shareholder and corporation); Rev. Rul. 72-601, 1972-2 C.B. 467 (father and son). Moreover, in Boise Cascade Corp. v. Commissioner, T.C. Memo. 1974-315, the Service argued, and the court's opinion acknowledged, that the parent/subsidiary relationship of the swapping parties in and of itself had no effect on the availability of section 1031 treatment to the transaction involved.

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[1] In the accommodating buyer cases, the buyer, under taxpayer's specific direction, buys the property that the taxpayer wishes to acquire before the exchange takes place. In those circumstances, the exchange qualifies under section 1031 for the taxpayer but not with respect to the accommodating buyer. That is because the buyer did not acquire the property it eventually passed on to the taxpayer with the requisite holding intent. Rev. Rul. 77-297, 1977-2 C.B. 304.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

In our earlier advice we counseled that there were few if any litigating hazards in asserting that the prearranged nature of the transaction and the recent creation of the particular corporate subsidiaries used in the deal created a bar to section 1031 nonrecognition treatment. In short, the "holding requirement" of the statute was left unfulfilled by Taxpayer when its subsidiaries merely acted as its agent (which is distinct from their related party status for an "agent" may be related or unrelated). Because of our presumption regarding that agency relationship here, the "intent" of the subsidiaries was thus attributable to Taxpayer. The subsidiaries intended to dispose of the [redacted] immediately, so section 1031 was unsatisfied. Given the economic reality of the transaction involved, we felt it was clear, notwithstanding the subsidiaries recognizing a small gain, it was the Taxpayer itself merely selling off old assets and buying new ones with the cash proceeds. While we believe that is still the correct answer. [redacted]

Even though we believe this proscribed agency situation and the cash-sale-with-reinvestment reality aptly describe the true nature of the transaction presented by this case, we must concede that the facts still remain that: (1) valid related party transfers under section 1031 have been allowed to occur (though inherently suspect, nonetheless) and that (2) the deal here closely resembles the permissible "trade-in" described in Rev. Rul. 61-119, 1961-1C.B. 395. Suspicion and supposition set aside, therefore, the other precedents seem to require that a firmer basis for showing that a subsidiary (or any related party) merely acted as an agent must be established.[2] In this case, that fact has probably not been adequately developed. See Fredericks v. Commissioner, T.C. Memo. 1994-27.

[redacted]

[2]In addition, although we will not cite them here, we noted at least seven private letter rulings involving section 1031 and various related parties where the relationship was never used to establish a disqualifying "agency."

[redacted][3]

By: _____
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[3] For example, whereas in Redwing Carriers, supra, there were "indicia of transactional unity" that established "a definite contractual interdependency between the sale of the new trucks and the trade-in of old trucks[,]" leading to the appropriate invocation of section 1031 treatment, on the facts currently before us, it cannot be similarly noted that "[t]here would have been no purchase . . . of new trucks or tractors [or airplanes here] . . . without concurrent and binding agreements to purchase [taxpayer's] used equipment." Id. at 655.