

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR: [REDACTED]; TL-N-5868-98
[REDACTED]

date: AUG 16 2000

to: [REDACTED]

from: District Counsel, [REDACTED]

subject: [REDACTED]

Consolidated Return Regulations and Application of I.R.C. § 1031

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You requested our advice on the an issue involving the consolidated return regulations and I.R.C. § 1031. Initially, we had questions about the facts in the case. However, upon reviewing the additional information you were able to acquire, we recommend that the no adjustment be made as discussed below.

A. ISSUE:

Whether the sale of certain properties by [REDACTED] to an unrelated third party triggered the recognition of deferred gain by [REDACTED] pursuant to Treas. Reg. § 1.1502-13(m).

B. FACTS:

[REDACTED] (" [REDACTED] ") and [REDACTED] (" [REDACTED] ") are wholly-owned domestic subsidiaries of [REDACTED] (" [REDACTED] "). [REDACTED] (" [REDACTED] ") is a wholly-owned domestic subsidiary of [REDACTED]. [REDACTED] (" [REDACTED] ") is a wholly-owned domestic subsidiary of [REDACTED]. [REDACTED] developed and sold residential property to homeowners in [REDACTED]. [REDACTED] also owned and sold property in [REDACTED].

1. First Sale/Exchange

In [REDACTED], [REDACTED] purchased an office tower and the underlying real estate (" [REDACTED] ") from [REDACTED] for \$ [REDACTED]. [REDACTED]'s basis in the [REDACTED] was \$ [REDACTED] and [REDACTED]'s gain from the sale was approximately \$ [REDACTED]. [REDACTED] deferred reporting [REDACTED]'s gain because the sale qualified as an inter-company transaction under the consolidated return regulations.

2. Second Sale/Exchange

[REDACTED] immediately exchanged the [REDACTED] for four properties owned by [REDACTED]. The four properties were [REDACTED] (" [REDACTED] ").

[REDACTED] applied I.R.C. § 1031² to [REDACTED]'s acquisition of the [REDACTED] through the exchange. It determined that [REDACTED] had a

¹ The taxpayer initially claimed that [REDACTED] was a dealer in real estate without providing any substantiation. Subsequently, [REDACTED] provided documentation supporting the its assertion.

² Under the current Treas. Reg. § 1.1502-80(f), I.R.C. § 1031 cannot be applied to any intercompany transaction. However, this regulation applies to intercompany transactions occurring in consolidated return years beginning on or after [REDACTED]. [REDACTED] can apply I.R.C. § 1031 to the intercompany exchange between [REDACTED] and [REDACTED].

substituted basis of \$ [REDACTED] in the [REDACTED] and that [REDACTED] was not required to report any gain. [REDACTED] determined that I.R.C. § 1031 was not applicable to [REDACTED]'s acquisition of the [REDACTED] properties through the exchange because [REDACTED] allegedly qualified as a dealer in real estate and planned to develop and sell the [REDACTED]. [REDACTED]'s basis in the [REDACTED] equaled what [REDACTED] had paid for the properties - \$ [REDACTED].

3. Third Sale/Exchange

In [REDACTED], [REDACTED] sold the [REDACTED] to an unrelated party. [REDACTED] reported the sale of the properties and the related losses. [REDACTED] still owned the [REDACTED] continued to defer reporting the gain [REDACTED] received on the initial sale of the [REDACTED] to [REDACTED].

C. LAW AND DISCUSSION:

In general, the current Treas. Reg. § 1.1502-13 applies to intercompany transactions occurring in years beginning on or after July 12, 1995. Treas. Reg. § 1.1502-13(1)(1). The applicable law for intercompany transactions occurring before that date is set forth below.

Under prior law, an intercompany transaction was generally defined as a transaction between corporations which were members of the same consolidated return group immediately after such transaction. Treas. Reg. § 1.1502-13(a)(1).³ The sale of property in an intercompany transaction was considered a deferred intercompany transaction. Treas. Reg. § 1.1502-13(a)(2). To the extent gain on a deferred intercompany transaction such as a sale was recognized under the Code for a consolidated return year, such gain was deferred by the selling member. Treas. Reg. § 1.1502-13(c)(1). [REDACTED]'s sale of the [REDACTED] to [REDACTED] qualified as a deferred intercompany transaction and [REDACTED] properly deferred recognizing its gain on the sale. [REDACTED]'s deferred gain shall be taken into account when the property sold is disposed of outside the group.

If property sold or exchanged in an intercompany transaction (or property the basis of which is determined, directly or

³ Unless otherwise indicated the discussions will involve the prior applicable regulations. These prior regulations were effective in taxable years wherein the due date of the return was after March 14, 1990, per prior Treas. Reg. § 1.1502-13(m)(4). The regulations were removed by Treasury Decision 8597, filed with the Federal Register on July 12, 1995. I.R.B. 1995-32, 6.

indirectly, in whole or in part, by reference to the basis of such property) is disposed of outside the group, any remaining deferred gain (and any associated tax consequences) shall be taken into account as if the selling member had disposed of the property at the same time and in the same manner as the property is disposed of outside the group.

Treas. Reg. § 1.1502-13(m)(1).

Whether [REDACTED] must recognize its deferred gain in [REDACTED] depends on whether the basis of the [REDACTED] sold by [REDACTED] was determined "directly or indirectly, in whole or in part," by reference to the basis of the [REDACTED]. Treas. Reg. § 1.1502-13(m)(1). To make this determination, the I.R.C. § 1031 exchange between [REDACTED] and [REDACTED] of the [REDACTED] and the [REDACTED] properties must be analyzed as that transaction defines [REDACTED]'s basis in the [REDACTED].

Gain or loss realized on the sale or exchange of property is recognized unless a specific nonrecognition rule in the Code provides otherwise. I.R.C. § 1001. The like-kind exchange rules are one such provision. I.R.C. § 1031. Section 1031 of the Code mandates 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." I.R.C. § 1031(a)(1).

The rationale for nonrecognition of tax in a like-kind exchange is that the newly acquired property is a continuation of the old investment, which remains unliquidated. The new property is viewed as a change in the form, but not in the substance, of the investment. To preserve the unrecognized gain, the basis in the property received is equal to the basis in the property transferred, with certain adjustments. I.R.C. § 1031(d). Thus, the gain is not tax-free, but merely deferred until the investment is liquidated.

Nonrecognition under the like-kind exchange rules requires that (1) there is an exchange of property; (2) the property transferred and the property received are of like kind; and (3) the property transferred and the property received are both held for productive use in the transferor's trade or business or for investment. I.R.C. § 1031(a)(1). One party to the exchange can qualify for I.R.C. § 1031 treatment with respect to property it received where the other party to the exchange may not. Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 84-121, 1984-2 C.B. 168.

The non-qualifying party's basis in the property it received was the fair market value of the property it transferred.

In this case, the listed requirements were met with one exception. With respect to the [REDACTED] received by [REDACTED], [REDACTED] intended to sell those properties as part of its residential real estate sales business. [REDACTED] was not going to hold the property for productive use in its business or for investment.

Property that is primarily held for sale shall not be eligible for non-recognition treatment. I.R.C. § 1031(a)(2). The basis of the [REDACTED] in the hands of [REDACTED] would be determined under I.R.C. §§ 1001, 1011, and 1012 which generally provide that "[t]he basis of property shall be the cost of such property." The cost of the [REDACTED] was \$ [REDACTED] - the fair market value of the [REDACTED] which [REDACTED] exchanged for the [REDACTED]. Therefore, [REDACTED]'s basis in the [REDACTED] was not either directly or indirectly⁴ determined by the basis of the [REDACTED].

D. CONCLUSION:

The disposal of the [REDACTED] by [REDACTED] did not trigger the recognition of [REDACTED]'s deferred gain.

[REDACTED]
Attorney

⁴ We could not find any discussion concerning the application of the term "indirectly" (found at I.R.C. § 1.1502-13(m)) with respect to determining the basis of real property.