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
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CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated January 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=
Related Party	=
Qualified Intermediary	=
Third Party 1	=
Third Party 2	=
Lender	=
Property X	=
Property Y	=
Property XY	=
Property Z	=
Date 1	=
Date 2	=
Date 3	=
Year 1	=
Year 2	=
Year 3	=

LEGEND (cont'd):

Father	=
Child 1	=
Child 2	=
Child 3	=
Child 4	=
Lender	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=

ISSUE(S):

1. Whether Taxpayer was entitled to nonrecognition of gain treatment under I.R.C. § 1031(a) in Year 2 on the exchange of Property X for an interest in Property Z.

2. Whether there are grounds either under section 1031(f)(1), or under another theory for including the gain on the exchange of Property X in Year 3.

CONCLUSION(S):

1. Taxpayer was not entitled to nonrecognition of gain on the exchange of Property X for an interest in Property Z in Year 2 under section 1031(a) because the transaction was structured to avoid the purposes of section 1031(f). Therefore, Taxpayer is subject to an adjustment in Year 2.

2. Although under section 1031(f)(4) it is proper to recognize the gain from the exchange of Property X in Year 2, we believe that, under the circumstances presented in this case, section 1031(f)(1) also supports an argument that the gain may be included in Year 3.

FACTS:

We rely on the facts set forth in your memorandum of January 13, 1999.

Father is a real estate developer. Father and his four children have interests in several related entities involved in developing real estate.

Prior to Year 1, E, a corporation owned by Father, purchased Property X from an unrelated party. Property X was eventually transferred in equal shares to the four children. The property was held as tenants-in-common by the four children under the name A. A leased Property X to B, a joint venture owned by Father, Child 1, Child 2 and two unrelated parties. B constructed Property Y on Property X. The entire property, Property XY, was leased to G.

Also prior to Year 1, Related Party, obtained financing from Lender to construct Property Z. The loan was secured, in part, by a second trust deed and assignment of rents on Property XY. Related Party is a corporation partially owned by Father, Child 1 and Child 3. Father, Child 1 and Child 3 own approximately 72% of the stock of Related Party.

In Year 1, A and B entered into an agreement with Third Party 1 for the sale of Property XY. The parties decided to structure the transaction as a like-kind exchange under section 1031. To facilitate the exchange, on Date 1 Taxpayer was formed as a general partnership by Child 1, Child 2, Child 3 and Child 4 as equal partners. D, a Subchapter S corporation, was incorporated by Child 2, Child 3 and Child 4, who contributed their interests in Taxpayer in exchange for equal shares of stock in D. In addition, C was formed as a limited partnership. Child 1 is the general partner and owns a 2.75% interest in C. Father and Child 2 are limited partners and together own an 88% interest in C.

In order to effectuate the like-kind exchange, on Date 1 A contributed its interest in Property X to Taxpayer and B contributed its interest in Property Y to C. A and B assigned to Taxpayer and C their respective interests in the purchase agreement with Third Party 1. In addition, Taxpayer and C entered into written exchange agreements with Qualified Intermediary. Under the agreements, Taxpayer and C agreed to transfer Property XY to Qualified Intermediary to complete the like-kind exchange.

Also on Date 1, Related Party entered into two purchase agreements with Qualified Intermediary. Under the agreements, Qualified Intermediary agreed to purchase an undivided 88% interest in Property Z plus assume some or all of the loan from

Lender. When the exchange was completed, Qualified Intermediary agreed to transfer a 51% interest in Property Z to Taxpayer and a 37% interest to C.

On Date 2, the loan from Lender was modified to allow for the release of Property XY from the second deed of trust. In exchange for the release of its security interest in Property XY, Lender was paid an amount from the net proceeds from the sale of the property to Third Party 1. The facts concerning the exact timing of the exchange are unclear; however, it is our understanding that the exchange occurred on or about Date 2. At this point Third Party 1 received Property XY and Taxpayer and C received 51% and 37% interests in Property Z, respectively.

On Date 3 in Year 3, Taxpayer, C and Related Party sold their interests in Property Z to Third Party 2. At this time Taxpayer, C and Related Party were released from their remaining obligations under the loan from Lender.

Taxpayer reported a loss on the sale of its interest in Property Z on its federal income tax return for Year 3. In addition, Taxpayer reported cancellation of indebtedness income.

Examination has issued a Notice of Final Partnership Administrative Adjustment (FPAA) to Taxpayer for Year 3. One of the adjustments requires Taxpayer to recognize gain from the exchange of Property X. The adjustment, made to taxable income in Year 3, is based on the determination that the property received in the exchange with Related Party was disposed of within 2 years from the date of the exchange. Therefore, under 1031(f)(1), there is no nonrecognition of the gain from the exchange. Year 2 was not a subject of the examination and no adjustments were proposed for that year.

LAW AND ANALYSIS

Section 1031(a)(1) provides generally 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)(1) provides special rules for exchanges between related persons. If, 1. a taxpayer exchanges property with a related person; 2. there is nonrecognition of gain or loss to the taxpayer in accordance with section 1031 with respect to the exchange; and, 3. 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 section

1031 must be recognized. Any gain or loss the taxpayer is required to recognize by reason of section 1031(f)(1) is taken into account as of the date of the disposition of the property. Generally, section 1031(f) applies to transfers after July 10, 1989, in tax years ending after that date.

A related person is defined under section 1031(f)(3) as any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

Section 267(b)(10) provides that a corporation and a partnership are related persons if the same persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or the profits interest, in the partnership.

The ownership of stock is determined under section 267(c)(2), which provides that an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family. Section 267(c)(4) provides that the family of an individual shall include only his brothers and sisters, spouse, ancestors and lineal descendants.

Section 707(b)(1)(A) disallows losses from sales or exchanges of property, directly or indirectly, between a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership. Section 707(b)(3) provides that for these purposes the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c).

Section 1031(f)(4) provides that section 1031 shall not apply to any exchange which is part of a transaction, or series of transactions, structured to avoid the purposes of subsection 1031(f). In other words, if a transaction is set up to avoid the restrictions on exchanges between related persons, section 1031(f)(4) operates to prevent nonrecognition of the gain or loss on the exchange.

Treas. Reg. § 1.1031(k)-1(g) provides for various safe harbors for deferred exchanges which result in a determination that the taxpayer is not in actual or constructive receipt of money or other property (not of like kind) for purposes of section 1031(a). One of the safe harbors listed in paragraph (g) is that of the qualified intermediary.

Treas. Reg. § 1.1031(b)-2 also provides a safe harbor for qualified intermediaries in the case of simultaneous transfers of like-kind properties. In such cases, the qualified intermediary, as defined in Treas. Reg. § 1.1031(k)-1(g)(4)(iii), is not considered the agent of the taxpayer for purposes of section 1031(a). The transfer and receipt of property by the taxpayer is treated as an exchange.

Treas. Reg. § 1.1031(k)-1(g)(4)(iii) defines a qualified intermediary as a person who is not the taxpayer or a disqualified person and who enters into a written agreement with the taxpayer to acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property and transfer the replacement property to the taxpayer.

In Tech. Adv. Mem. 97-48-006 (Nov. 28, 1997), the taxpayer held a one-third interest in real property and the taxpayer's mother held the remaining two-thirds interest. An unrelated party wanted to purchase the entire parcel held by the taxpayer and his mother for cash. The parties entered into a sales agreement. Subsequently, the taxpayer's mother purchased another property (Property 2) to use as a personal residence.

After entering into the sales contract, the taxpayer decided that he wanted to arrange a like-kind exchange. He initially attempted to acquire replacement property from a second unrelated party, but was unsuccessful in negotiating a deal in time for the exchange to qualify. Instead, the taxpayer entered into an agreement to purchase Property 2 from his mother as replacement property.

The transaction was arranged using a qualified intermediary. The taxpayer transferred his interest in the relinquished property and his rights and obligations under the sales contract with the unrelated party to the qualified intermediary. He also transferred his rights and obligations under the contract with his mother for the purchase of Property 2 to the qualified intermediary. The qualified intermediary then sold the taxpayer's interest in the relinquished property to the unrelated party and used the proceeds to pay the taxpayer's mother for Property 2. Then, the qualified intermediary transferred title of Property 2 to the taxpayer. In a separate, but concurrent transaction, the unrelated party purchased the remaining two-thirds interest in the relinquished property from the taxpayer's mother. The entire exchange took place on one day.

The technical advice did not address the issue of the treatment of nonrecognized gain where the exchanged property is subsequently disposed of by one of the related parties. Instead, advice was requested on the issue of whether the taxpayer was eligible for nonrecognition treatment with respect to the exchange under section 1031(a). It was determined that the taxpayer was not entitled to nonrecognition of gain on the above-described transaction. The basis for this determination was section 1031(f)(4), which prevents related parties from circumventing subsection (f)(1) by structuring their transactions to avoid the related party rules. See H.R. Rep. No. 247, 101st Cong., 1st Sess. 1339, 1341 (1989).

The technical advice concluded that, in substance, the result of the series of exchanges was identical to what would have occurred in a direct exchange of property between the taxpayer and his mother, followed by a sale of the property by the taxpayer's mother to the unrelated party. The facts did not suggest that the qualified intermediary was needed to prevent constructive receipt of money or other property not of a like kind. In fact, the sole consequence of eliminating the qualified intermediary appeared to be the disqualification of the exchange under section 1031(f). If the qualified intermediary had been eliminated from the transaction, the taxpayer would have had to recognize gain on the exchange under section 1031(f) when his mother sold the property to the unrelated party within 2 years of the exchange. Because the taxpayer was unable to show that the qualified intermediary had a substantive purpose in the transaction, the Service reasoned that the exchange was structured to avoid application of the related party rules and, accordingly, concluded that section 1031(f)(4) operated to preclude nonrecognition of gain under section 1031(a).

Although they are more far more complicated, the facts of the instant case bear many similarities to the facts outlined in the technical advice. For example, the transaction in Year 2 is between related persons within the meaning of section 1031(f)(3).

Taxpayer is a partnership owned by Child 1 and D, a corporation owned by Child 2, Child 3 and Child 4. Related Party is a corporation, 72.04% of which is owned by Father, Child 1 and Child 3. Under section 267(b)(10), a corporation and a partnership are related if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or the profits interest in the partnership. Child 1 may be considered as owning the stock owned by his brother and sisters under section 267(c)(2). Accordingly, Child 1 constructively owns 100% of D and, therefore, 100% of Taxpayer. Similarly, with respect to Related Party, Child 1 may be considered as owning the stock of his father and sister under section 267(c)(2). Thus, Child 1 constructively owns 72.04% of Related Party also.

Under the attribution rules, the same person owns more than 50% of Taxpayer and Related Party. Therefore the two entities are related persons within the meaning of section 1031(f)(3) and exchanges between the two entities are subject to the special rules for exchanges between related persons under section 1031(f).

In the instant case, like the technical advice, a qualified intermediary was used to complete the exchange between Taxpayer and Related Party in a transaction that included the simultaneous sale of Taxpayer's property to an unrelated party. Further, like the technical advice, it does not appear that a straight exchange with

Related Party would have been disqualified by the constructive receipt of money or other property not of a like kind. Thus, like the technical advice, there is no obvious reason for interposing a qualified intermediary in the transaction. However, if the transaction had been structured as a straight exchange with Related Party and a subsequent sale from Related Party to Third Party 1, the exchange would not have qualified for nonrecognition treatment under section 1031(f)(1). Thus, as in the technical advice, it appears that the interposition of the qualified intermediary had no purpose except to prevent the exchange from disqualification from nonrecognition treatment under section 1031(f)(1). Accordingly, we agree with your conclusion that the facts of this case support the argument that the exchange in Year 2 was set up to avoid the related party rules.

Although the regulations provide for the use of a qualified intermediary to effect a like-kind exchange, the statute makes clear that a qualified intermediary may not be used to circumvent the related party rules. As stated in the technical advice, the mere interposition of a qualified intermediary cannot correct a transaction otherwise flawed under section 1031 (f)(1). Thus, in accordance with section 1031(f)(4), section 1031(a) does not apply to the exchange between Taxpayer and Related Party in Year 2. Because section 1031(a) does not apply to the exchange, any gain from the exchange is subject to recognition in Year 2.

However, we believe the Service is also permitted to make an adjustment in Year 3. In the instant case, unlike the situation in the technical advice, Taxpayer sold the replacement property to Third Party 2 in Year 3. This sale was in contravention of the requirements of section 1031(f)(1) because it occurred within 2 years of the initial exchange.

Section 1031(f)(1) provides that where gain from an exchange between related persons has not been recognized and the property is disposed of within 2 years of the exchange, there is no nonrecognition of gain from the exchange. The statute further provides that in such cases the recognition of gain should be taken into account as of the date of the disposition of the property. Section 1031(f)(1)(B) specifically provides that the determination of whether the gain or loss from the initial exchange was recognized should be made without regard to the subsection (f) related party rules: "If. . .there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property <u>(determined without regard to this subsection)</u>." I.R.C. § 1031(f)(1)(B) (emphasis added).

In this case, if the related party rules of section 1031(f) are not taken into account, i.e. the rule under section 1031(f)(4), there was nonrecognition of gain under section 1031(a) with respect to the exchange between Taxpayer and Related Party in Year 2. Certainly nonrecognition treatment was claimed by Taxpayer and benefits were received in Year 2. Further, the replacement property was disposed of in Year 3, within 2 years of the exchange in contravention of the requirements of section 1031(f)(1)(C). Thus, the facts of the instant case fall squarely within the parameters of section 1031(f)(1). Given these facts, section 1031(f)(1) expressly authorizes an adjustment to recognize the gain from the exchange as of the date of the disposition of the property in Year 3. We find nothing in the statutory language or in the legislative history to indicate that the applicability of section 1031(f)(4) precludes or supersedes the applicability of section 1031(f)(1). Therefore, assuming the facts support the argument, as they appear to in this case, we believe it is proper to take the position we are permitted to make an adjustment under section 1031(f)(1) in the year the replacement property is disposed of notwithstanding the fact that an adjustment could have been made in a prior year under section 1031(f)(4).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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If you have any further questions, please call (202) 622-7900.

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