Real Estate Tax Alert

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Introduction

The Internal Revenue Service (the "Service") recently issued two Private Letter Rulings, 201216007 and 201220012, regarding the treatment of like-kind exchanges with related parties. The primary question raised in each PLR was whether a taxpayer is permitted to defer gain as provided by Internal Revenue Code ("Code") Section 1031(a) when the taxpayer engages in a series of transactions with related parties and each transaction in the series of transactions would otherwise qualify as a like-kind exchange when viewed separately. The Service concluded in both instances that the transactions would not be disqualified from the nonrecognition provisions of Code Section 1031. While these rulings may not be relied upon by taxpayers as precedent, they do provide taxpayers with insight into the Service's general view of exchanges with related parties and what the Service may accept as a non-material disposition of non-like-kind property in a related party context.

Relevant rules

Code Section 1031 generally provides that no gain or loss is recognized by a taxpayer if qualifying property is exchanged for property of "like-kind," provided that certain statutory provisions are met. Although a taxpayer is not prohibited from executing a like-kind exchange with a related party under these nonrecognition provisions, the legislative, administrative and judicial history present some obstacles that may force a taxpayer to recognize gain on exchanges of qualifying property with related parties.

The related party exchange rules were added to the Code to limit certain like-kind exchanges between related parties. The overall goal of this provision is to attempt to prevent basis shifting, whereby a taxpayer exchanges high basis property for low basis property in order to reduce or avoid the recognition of gain or accelerate losses on the subsequent sale of exchanged property. Under these provisions, a gain or loss on an exchange of property between related parties generally must be recognized if either the replacement property or property transferred to the related party is disposed of within a two-year period following the date of the exchange. However, recognition of gain or loss may still be deferred if a taxpayer can establish to the satisfaction of the Service that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax.

Still, the Code provides that if any transaction is structured to avoid the related-party exchange rules, the nonrecognition provisions will not apply to an exchange (the "anti-avoidance rule"). Therefore, even though the related-party exchange rules may not apply to an exchange due to the use of a QI (which is not related to the taxpayer), the anti-avoidance rule may still disallow nonrecognition treatment for part or a series of transactions if the use of a QI was structured to avoid the related-party exchange provisions.

Facts applied in the rulings

While the facts in both PLRs were not identical, taxpayers in each ruling utilized parking arrangements described in Rev. Proc. 2000-37 in which a taxpayer may enter into exchanges with a qualified intermediary ("QI") which enters into agreements to sell the relinquished property to the party ultimately acquiring the property originally held the taxpayer and to acquire the replacement property from the party holding the property that the taxpayer wishes to acquire. As part of each arrangement, replacement property from a related party, within the meaning of Section 1031, was acquired by the taxpayer. The related parties engaged in separate 1031 transactions and acquired replacement property with respect to the property transferred.

Each taxpayer represented that any amount of non-like-kind property that the affiliate would receive in an exchange would not exceed 5% of the gain realized on the transfer. The taxpayers and their affiliates also represented that they intended to hold the replacement property for at least two years after the last transfer of property in the series of exchanges.

IRS conclusion and application to taxpayers

Consistent with previous rulings issued on the matter, the Service concluded that the related-party exchange rules did not directly apply to the taxpayers' exchanges because the exchanges were not direct exchanges with a related person, but rather exchanges with an unrelated QI that was utilized to facilitate the exchanges. While the anti-avoidance provisions could still apply, the Service concluded that, even though the parties in the transaction might recognize up to 5% of the gain realized on their transferred property, there was no "material cashing out" by any related-party in the series of transactions and therefore there was no intent to avoid the purposes of the related party exchange rules. The Service appeared satisfied that all related parties would end up owning property that is of like-kind to the properties exchanged upon completion of the exchanges, that there would only be limited gain recognized on the exchanges and that the related parties intended to hold the property that they acquired at the end of the series of like kind exchanges for a period in excess of two-years after the exchanges.

For taxpayers with legitimate business reasons that require the execution of a related-party exchange, PLR 201216007 and 201220012 confirm that the Service will likely accept a disposition of non-like-kind property provided that the amount recognized is not material. Although the rulings give no indication as to what amount constitutes "material" for this purpose, an amount equal to 5% of the realized gain was accepted by the IRS in each case.

A private letter ruling binds only the IRS and the requesting taxpayer. Thus, a private ruling may not be cited or relied upon as precedent.

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