A RAILROAD PROGRAM EXCHANGE DERAILED

Sometimes, the little things that are taken for granted are the ones that cause an exchange transaction to fail. An interesting example of this happened in Technical Advice Memorandum (TAM) 200424001, released on June 11, 2004.

Facts: The taxpayer in the TAM was a Class I railroad operator. The taxpayer had a program exchange with a qualified intermediary (QI) for both real and personal property. The taxpayer sold non-core real estate and personal property and placed the proceeds in an account with a QI. The documentation and procedures for the exchanges was not an issue. At issue was the treatment of "line sales" and scrap sales of rails, ties, and ballast. Other issues discussed in the TAM are not discussed here, including appropriate methods of accounting.

Relinquished Property: In a line sale, taxpayer sells operating segments of its rail lines to another railroad operator. A "line" consists of the rights of way, together with the rails, ties, and ballast that compose the rail bed, together with bridges, tunnels, bores, and switching apparatus. Other relinquished proceeds were generated from rails, ties, and ballast sold to recyclers as scrap. Sale proceeds were sent to the QI.

Replacement Property: The proceeds were used to buy component materials, including rails, ties, and ballast. The most expensive component was steel rail segments used by the taxpayer in performing maintenance, program replacements, and new track construction. The proceeds were used to pay for materials that were purchased by taxpayer and stored for usage in performing repairs, major replacements, and new construction.

Result and Analysis: The IRS denied like-kind exchange treatment for exchanges of line sales to track construction components. The principal reason was that the relinquished property in a line sale was considered real estate, and the replacement property was personal property. At the time of sale, the line consisted of the rights of way and improvements. Many line components are depreciated as personal property. Some line components, such as bridges, trestles, and tunnels are unquestionably real estate. Rail lines were sold in a number of different states. The IRS did not analyze any state's local real estate law, but assumed for audit purposes that the rail lines were affixed to the land and consequently real estate.

Lessons Learned: The taxpayer depreciated the relinquished and replacement property as personal property. The analysis does not stop here. Regardless of its characterization for depreciation purposes, it is important to look at the nature or character of the relinquished property as real or personal for Section 1031 purposes. This requires not just looking at the components sold, but how they are sold. Contrast this to the taxpayer's scrap sales of rails, ties, and ballast, which were unattached personal property when sold. In any like-kind exchange of property it is important to satisfy BOTH the requirements of §1031 and the recapture provisions of Sections 1245 and 1250. Anyone selling assets that are real property (under state law) that is also §1245 property, must match with sufficient replacement property value in respect to both real estate and §1245 property.

Several things could have led to a different result in the TAM. If the rails, ties, and ballast were sold apart from the real estate interest (the right of way), a different result may occur. Also, a line sale for another line sale would likely produce a different result. If the QI acquired an interest in a railroad right of way and paid for component expenditures as they became affixed to the real estate (i.e., an "improvement exchange"), their character would have been real rather than personal property, and the IRS would have had a more difficult analysis. This type of exchange would require the taxpayer to identify replacement property under the requirements applicable to real estate under construction (unless the acquisition occurred during the identification period). By attaching the personal property to rights of way already owned, the taxpayer would need to address or distinguish the applicability of Bloomington Coca Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir., 1951), which the IRS did not need to address in the TAM.

It is easy to overlook the value of a sophisticated, experienced QI that will work with the taxpayer and its advisors to critically look at the exchange structure and make recommendations or help troubleshoot possible issues such as the taxpayer in this TAM faced. Please feel free to use Compass as a resource to discuss your difficult exchange issues so YOUR exchange does not get derailed.