

**Internal Revenue Service**

Department of the Treasury  
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February 7, 2012

TY:

Legend

- Prime Taxpayer (PT) =
- Affiliate =
- Related Party =
- Parent =
- Subsidiary =
- LLC#1 =
- Holding =
- Affiliate LLC =
- Unrelated Buyer =
- RQ =
- RP (Affiliate RQ) =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- \$x =
- \$y =

Dear

This responds to your request for a private letter ruling, dated August 11, 2011, submitted on behalf of Prime Taxpayer (PT), Affiliate, and Related Party, regarding the application of § 1031(f) of the Internal Revenue Code to their exchanges of property. The primary question you raise is whether § 1031(f) makes the benefits of § 1031(a) unavailable for taxpayers engaging in a series of transactions with related parties when each transaction in the series otherwise qualifies for deferral under § 1031(a), and none of the parties receive more than a minimal amount of non-like-kind property in their

transactions. PT, Affiliate and Related Party also request rulings on the manner in which the identification and replacement period rules apply in the transactions.

#### FACTS:

##### 1. PT's Organizational Identity and Structure.

PT is a limited partnership. Parent is a real estate investment trust (REIT). PT is the operating partnership for Parent, which operates through an UPREIT structure. Parent owns 95.5 percent of the interests in PT and is its sole general partner. Various outside partners own the remaining 4.5 percent of the interests in PT. PT conducts its operations and owns properties directly and through various subsidiary entities, including single-member limited liability companies that are disregarded for federal income tax purposes. One of these is LLC#1, the owner of PT's relinquished property (RQ).

PT also has interests in other subsidiary entities that are not disregarded for federal income tax purposes. One of these is Affiliate, which is a limited partnership that is 99.99 percent owned by PT. The other .01 percent is held by Holding, a corporation. PT owns 100 percent of Holding. Parent and Holding have jointly elected to treat Holding as a taxable REIT subsidiary under § 856(l) of the Code. Another of these entities is Related Party, a limited liability company 99 percent owned by Taxpayer and 1% by Subsidiary. Subsidiary is a corporation that is wholly owned by Parent.

##### 2. The Exchange Transactions.

###### A. PT's Exchange

PT engaged in a deferred like-kind exchange through a qualified intermediary (QI) and a qualified trustee (QT) under an exchange agreement and a qualified exchange trust agreement.<sup>1</sup> On Date 1, PT (by its wholly-owned LLC#1), pursuant to the exchange agreement and a prior sales agreement, conveyed RQ by direct deed to Unrelated Buyer for \$x.

On Date 2, PT timely identified replacement property (RP) as a potential replacement property for RQ, along with two other potential replacement properties. RP was owned

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<sup>1</sup> The term "qualified exchange trust agreement" as used in this letter is the type of trust agreement described in § 1.1031(k)-1(g)(3)(iii) of the Income Tax Regulations. Taxpayer describes specific steps in these combined transactions, including Taxpayers entering into exchange agreements, qualified exchange trust agreements, assignments, notices of assignments, etc., and represents that PT, Affiliate and Related Party are meeting all requirements for deferral in these transactions under the safe harbor rules of the regulations and other relevant published guidance. Since these steps are not directly relevant to the rulings sought by Taxpayer, this letter will not describe them with the same amount of detail given in Taxpayer's ruling application.

by Affiliate through its wholly-owned limited liability company, Affiliate LLC, a disregarded entity for federal income tax purposes.

On Date 3, PT timely acquired RP when it acquired from Affiliate 100 percent of the membership interest of Affiliate LLC for \$y, an amount exceeding the sales price of RQ.

#### B. Affiliate's Exchange

Affiliate entered into an exchange agreement and a qualified exchange trust agreement to facilitate the exchange of RP (Affiliate RQ) for like-kind replacement property (Affiliate RP). At the closing of the transfer of RP (which was Affiliate RQ) to PT, the net proceeds were received by Affiliate's QI and QT. On Date 4, Affiliate timely identified three properties as potential replacement properties for Affiliate RQ. One of these identified properties is held by Related Party.

If Affiliate acquires Affiliate RP at a cost that is less than the amount realized on the disposition of Affiliate RQ, the difference will result in Affiliate recognizing gain equal to the difference. However, Affiliate represents that the amount of gain Affiliate will have to recognize as a result of acquiring Affiliate RP for less than the amount realized for Affiliate RQ will not exceed 5 percent of the gain realized by Affiliate on its disposition of Affiliate RQ.

#### C. Additional Related Party Exchanges

To the extent any Affiliate RP is acquired from Related Party, prior to transfer of such property to Affiliate, Related Party will enter into a deferred exchange agreement with a QI providing for the Related Party's exchange of Affiliate RP that it transfers to Affiliate. Thus the Affiliate RP to be transferred by Related Party will be Related Party's relinquished property (Related Party RQ).

Before the expiration of the statutory identification period, Related Party will identify potential replacement properties (Related Party RP). All potential Related Party RP will be owned by parties unrelated to PT, Affiliate and Related Party. Related Party will acquire ownership of some or all of the potential Related Party RP within the replacement period provided in § 1031(a)(3)(B).

If Related Party acquires Related Party RP through a QI at a cost that is less than the amount realized on the disposition of Related Party RQ, the difference will result in Related Party recognizing gain equal to the difference. However, Related Party represents that the amount of gain Related Party will have to recognize will not exceed 5 percent of the gain realized by Related Party on its disposition of the Related Party RQ.

PT, Affiliate and Related Party receiving replacement properties from related parties in the series of exchanges described in this letter will hold their replacement properties for at least two years following the date of the acquisition of the last property acquired by any of the parties in these described transactions.

#### APPLICABLE LAW & ANALYSIS:

##### *Application of § 1031(f)*

Section 1031(a)(1) of the Code provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind to be held either for productive use in a trade or business or for investment.

Section 1031(f)(1) provides that if--(A) a taxpayer exchanges property with a related person, (B) there is nonrecognition of gain or loss to the taxpayer under § 1031 on the exchange of such property (determined without regard to § 1031(f)), and (C) before the date 2 years after the date of the last transfer that was part of the exchange—

- (i) the related person disposes of the property, or
- (ii) the taxpayer disposes of the property received in the exchange from the related person that was of like kind to the property transferred by the taxpayer,

there is no nonrecognition of gain or loss under § 1031 to the taxpayer on the exchange. Any gain or loss recognized by the taxpayer by reason of §1031(f) must be taken into account as of the date on which the disposition referred to in (C) occurs.

Section 1031(f)(2)(C) provides that, for purposes of the application of § 1031(f)(1)(C), a disposition is not taken into account if it is established to the satisfaction of the Secretary that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax.

Section 1031(f)(4) provides that § 1031 does not apply to any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of § 1031(f).

Section 1031(f)(1) is not applicable to PT's exchange of RQ for RP because PT is exchanging property with QI, who is not a related person to PT. The same is true of the separate exchanges of Affiliate and Related Party. However, under § 1031(f)(4), if PT (or Affiliate or Related Party) is using a QI or EAT to structure its transactions with tax avoidance as one of its principal purposes, § 1031 will not apply to the exchange. See, e.g., *Teruya Brothers Ltd. v. Commissioner*, 580 F.3d 1038 (9<sup>th</sup> Cir. 2009); *Ocmulgee Fields v. Commissioner*, 613 F.3d1360 (11<sup>th</sup> Cir. 2010); and Rev. Rul. 2002-83, 2002-2 C.B. 927.

Both the House Ways and Means Committee and the Senate Finance Committee disclosed the policy concern that led to the enactment of § 1031(f):

Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on the retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, cashed out of the investment, and the original exchange should not be accorded nonrecognition treatment.

H.R. Rep. No. 247, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess., 1340 (1989); S. Print. No. 56, at 151 (1989).

The Senate Finance Committee Print, however, also gives three examples of fact situations for which it is deemed established for purposes of § 1031(f)(2)(C) that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax. One of the three involves “. . . dispositions of property in nonrecognition transactions.” S. Print. No. 56, 152.

In the present case, the only acquisitions of replacement property from related entities will be as part of subsequent like-kind exchanges by these related entities, which will substantially constitute nonrecognition transactions. Affiliate will be relinquishing property to PT as part of its own like-kind exchange with Related Party and Related Party will relinquish property to Affiliate as part of its separate like-kind exchange for replacement property from one or more unrelated parties. Since both Affiliate and Related Party are also structuring their respective dispositions of property as exchanges for like-kind replacement property, neither § 1031(f)(1) nor (f)(4) will apply to trigger gain recognition in PT's exchanges or to disqualify the application of § 1031 to any exchange in this series of transactions.

Furthermore, there is no material cashing out by any of the related parties within 2 years of the last transfer in the series of transactions because neither Taxpayer, Affiliate nor Related Party will receive non-like-kind replacement property greater than 5 percent of the gain realized on disposition of relinquished property. Upon completion of the series of transactions, all related parties will own the properties received in these exchanges that are of like kind to the properties exchanged for at least two years after the date of the last transfer in the series.

*Application of the identification and replacement period rules*

Section 1031(a)(3) provides that for purposes of § 1031(a), any property received by the taxpayer is treated as not like-kind property if—

(A) the property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) the property is received after the earlier of—

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

Section 1.1031(k)-1(c)(4) provides rules limiting the number and the fair market value of potential replacement properties that exchanging taxpayers may identify prior to their receipt of replacement property.

In the present case, PT, Affiliate and Related Party represent that they are separate taxpayers that will separately report the results of any exchange, including the realization and recognition of gain or loss on the dispositions. Thus, each must be regarded as undertaking its own exchange transaction with an identification and replacement period that would apply separately to that party's exchange. Thus, for example, Date 1 would be the day on which PT's 45-day identification period would begin, whereas Affiliate's identification period would begin when Affiliate transfers its RQ and Related Party's identification period begins when Related Party transfers its RQ. Similarly, each party would separately apply the limits on identification of multiple or alternative properties under §1.1031(k)-1(c)(4).

#### RULINGS:

1. Section 1031(f)(1) and (f)(4) of the Code do not apply to disqualify PT from the benefits of § 1031(a) in its exchanges with related parties provided that (A) each related party transferring replacement property into the exchanges described in this letter is also engaging in its own like-kind exchange and (B) PT, Affiliate and Related Party hold their replacement properties for at least two years after the date of the last transfer of property in the exchanges.
2. Receipt by Affiliate or Related Party of non-like-kind property equal to no more than 5 percent of the gain realized by Affiliate or Related Party, respectively, in its exchange will not result in the application of § 1031(f) to PT in its exchange.
3. Each transfer of relinquished property by PT, Affiliate or Related Party in its separate exchange will result in a separate identification period and replacement

period provided in § 1031(a)(3) commencing on the date of the respective party's initial transfer of relinquished property.

4. Each transfer of relinquished property by PT, Affiliate or Related Party in its separate exchange will result in a separate application of the limits on identification of multiple or alternative replacement properties provided in §1.1031(k)-1(c)(4).

CAVEATS:

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The ruling contained in this letter is based upon information and representations submitted by PT, Affiliate and Related Party and accompanied by a penalty of perjury statement executed by an appropriate party. This ruling is also based upon the representation that PT, Affiliate and Related Party receiving replacement properties from related parties in the series of exchanges described in this letter will hold their replacement properties for at least two years following the date of the acquisition of the last property acquired by any of the parties in these described transactions.

While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro  
Chief, Branch 4  
(Income Tax & Accounting)

cc: