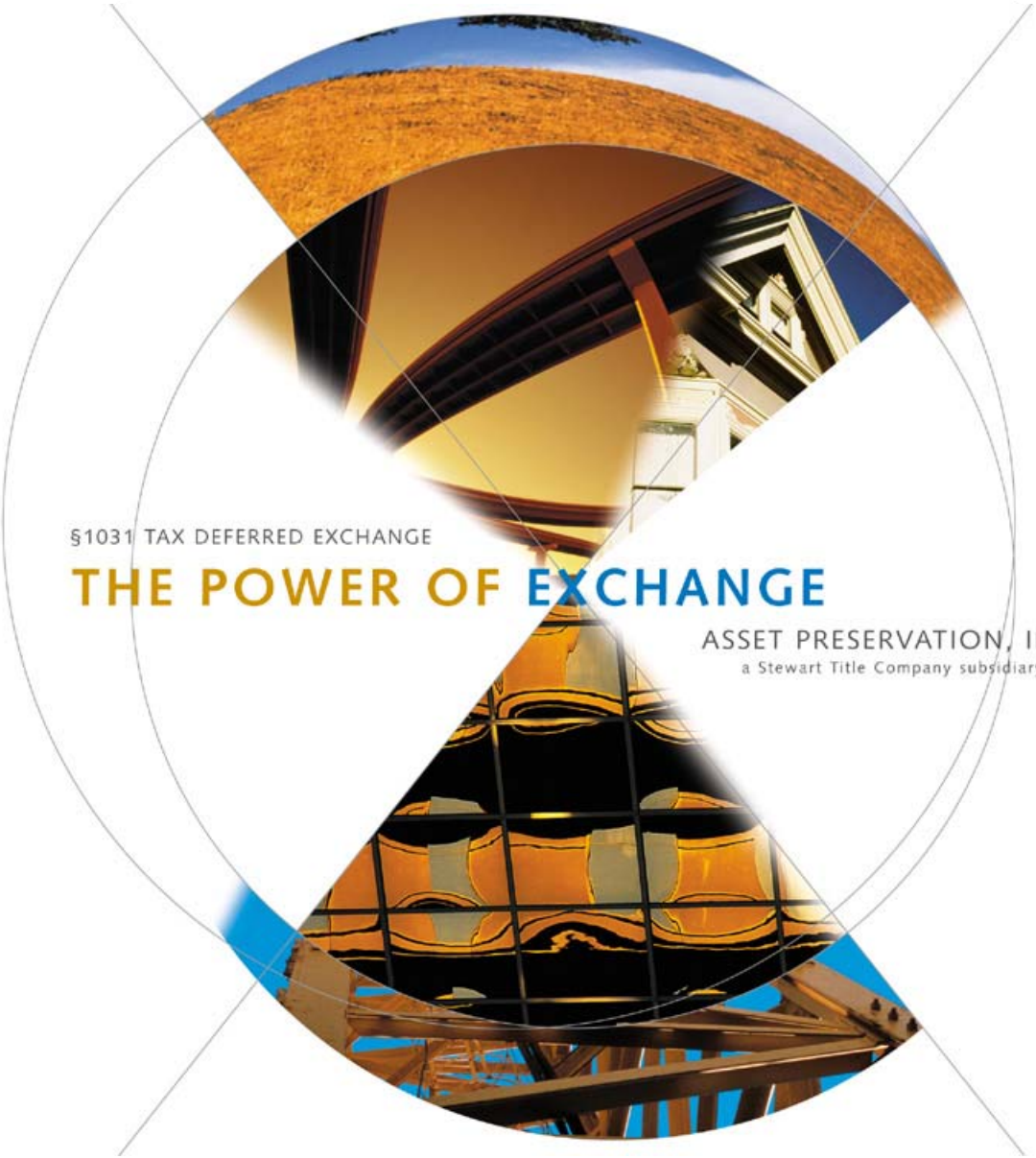
The IRC §1031 Tax Handbook

REFERENCE INFORMATION FOR LEGAL AND TAX ADVISORS



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INTRODUCTION

Asset Preservation, Inc. (API) has prepared The IRC Section1031 Tax Handbook to provide taxpayers and their advisors with useful information about §1031 tax deferred exchanges. This handbook is only intended to provide a broad overview of §1031 and the Treasury Regulations and does not address all tax deferred exchange issues. API does not provide legal or tax advice. Every taxpayer is urged to seek independent legal and/or tax advice as the tax laws often change and can affect the validity of a §1031 exchange.

For updated tax information, go to the Internal Revenue Service website, www.irs.gov. Please call Asset Preservation toll-free at 800-282-1031 to speak with our in-house counsel or one of our experienced Senior Exchange Counselors. Visit Asset Preservation's website, www.apiexchange.com, click on "More Info" and then "All Topics" to access over one hundred detailed Power of Exchange™ articles dealing with a wide range of §1031 exchange issues.

THE API ADVANTAGE™

As a leading national qualified intermediary, API is committed to providing its exchange clients with unmatched customer service and the highest level of security available in the §1031 exchange industry. From the client's first contact with an API representative, API's professional exchange counselors, attorneys and accountants work together to meet the client's service needs in order to ensure a smooth transaction with no surprises. In the background, API management maintains tight financial controls and multi-layered security systems necessary to provide a level of comfort and the quality of performance relied on by sophisticated investors and Corporate America; we call it the "*The API Advantage*™."

EXPERIENCE

- Established in 1990, API has successfully facilitated over 130,000 tax deferred exchanges.

EXPERTISE

- API's Exchange Counselors, attorneys and accountants provide personal attention to each exchange.
- API's specialized Commercial Division staff handles complex exchange transactions where sophistication, speed and institutional flexibility are needed to get the job done.
- API is a member in good standing of the Federation of Exchange Accommodators, the tax deferred exchange industry's only national trade organization.
- API's staff is available for free consultation regarding all §1031 exchange matters.
- API's website includes the ability to initiate a tax deferred exchange 24/7.

SECURITY

- API maintains a fidelity bond with coverage in the aggregate amount of $25,000,000 and has Errors & Omissions coverage in the amount of $2,000,000. API has implemented other protections for its clients that go beyond the typical protections offered by other qualified intermediaries.
- API is a member of the Stewart Family of companies under the umbrella of Stewart Information Services, Inc. (Stewart), a NYSE publicly traded company. Stewart Title Company, Inc. (STC) issues a Letter of Assurance (LOA) to each of API's exchange clients upon request. Under the terms of this LOA, STC assures API's performance of its obligations under its Exchange Agreement. The coverage provided by the LOA is not limited to a specific dollar amount like a bond or Errors & Omissions coverage.

A separate Exchange Account is established for each client. Exchange funds are not commingled with API's operating accounts. The client may require a notarized signature for the movements of funds – a security feature that assures exchange funds are disbursed only at the direction of the client.

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SECTION 1031

Sec. 1031
Exchange of property held for productive use or investment

(a) Nonrecognition of gain or loss from exchanges solely in kind

(1) In general

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.

(2) Exception. This subsection shall not apply to any exchange of—

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests, or

(F) choses in action.

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property. For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

(A) such 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) such 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 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.

(b) Gain from exchanges not solely in kind

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from exchanges not solely in kind

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) Basis

If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other

property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

(e) Exchanges of livestock of different sexes

For purposes of this section, livestock of different sexes are not property of a like kind.

(f) Special rules for exchanges between related persons

(1) In general

If—

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange—

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer, there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

(2) Certain dispositions not taken into account

For purposes of paragraph (1)(C), there shall not be taken into account any disposition—

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) Related person

For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) Treatment of certain transactions

This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

(g) Special rule where substantial diminution of risk

(1) In general

If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

(2) Property to which subsection applies

This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by—

(A) the holding of a put with respect to such property,

(B) the holding by another person of a right to acquire such property, or

(C) a short sale or any other transaction.

(h) Special rules for foreign real and personal property

For purposes of this section—

(1) Real property

Real property located in the United States and real property located outside the United States are not property of a like kind.

(2) Personal property

(A) In general

Personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind.

(B) Predominant use

Except as provided in subparagraph (C) and (D), the predominant use of any property shall be determined based on—

(i) in the case of the property relinquished in the exchange, the 2-year period ending on the date of such relinquishment, and

(ii) in the case of the property acquired in the exchange, the 2- year period beginning on the date of such acquisition.

(C) Property held for less than 2 years

Except in the case of an exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection —

(i) only the periods the property was held by the person relinquishing the property (or any related person) shall be taken into account under subparagraph (B)(i), and

(ii) only the periods the property was held by the person acquiring the property (or any related person) shall be taken into account under subparagraph (B)(ii).

(D) Special rule for certain property

Property described in any subparagraph of section 168(g)(4) shall be treated as used predominantly in the United States.

TREASURY REGULATION — SECTION 1.1031

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[T.D. 8346, 56 FR 19937, May 1, 1991]

Sec. 1.1031(a)-1
Property held for productive use in trade or business or for investment.

(a) In general--(1) Exchanges of property solely for property of a like kind. Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under section 1031(a)(1), property held for investment may be exchanged for property held for productive use in a trade or business. However, section 1031(a)(2) provides that section 1031(a)(1) does not apply to any exchange of—

(i) Stock in trade or other property held primarily for sale;

(ii) Stocks, bonds, or notes;

(iii) Other securities or evidences of indebtedness or interest;

(iv) Interests in a partnership;

(v) Certificates of trust or beneficial interests; or

(vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a). (2) Exchanges of property not solely for property of a like kind. A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). Similarly, a transfer is not within the provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(b) Definition of ``like kind.'' As used in section 1031(a), the words like kind have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. For additional rules for exchanges of personal property, see Sec. 1.1031 (a)-2.

(c) Examples of exchanges of property of a ``like kind.'' No gain or loss is recognized if

(1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or

(2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) Examples of exchanges not solely in kind. Gain or loss is recognized if, for instance, a taxpayer exchanges

(1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or

(2) a real estate mortgage for consolidated farm loan bonds.

(e) Effective date relating to exchanges of partnership interests. The provisions of paragraph (a)(1) of this section relating to exchanges of partnership interests apply to transfers of property made by taxpayers on or after April 25, 1991.

Sec. 1.1031(a)-2
Additional rules for exchanges of personal property.

(a) Introduction. Section 1.1031(a)-1(b) provides that the nonrecognition rules of section 1031 do not apply to an exchange of one kind or class of property for property of a different kind or class. This section contains additional rules for determining whether personal property has been exchanged for property of a like kind or like class. Personal properties of a like class are considered to be of a ``like kind'' for purposes of section 1031. In addition, an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Under paragraph (b) of this section, depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in paragraph (b)(2) of this section) or within the same Product Class (as defined in paragraph (b)(3) of this section). Paragraph (c) of this section provides rules for exchanges of intangible personal property and nondepreciable personal property.

(b) Depreciable tangible personal property—

(1) General rule. Depreciable tangible personal property is exchanged for property of a ``like kind'' under section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property's General Asset Class or Product Class is determined as of the date of the exchange.

(2) General Asset Classes. Except as provided in paragraphs (b)(4) and (b)(5) of this section, property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property that frequently are used in many businesses.

The General Asset Classes are as follows:

(i) Office furniture, fixtures, and equipment (asset class 00.11),

(ii) Information systems (computers and peripheral equipment) (asset class 00.12),

(iii) Data handling equipment, except computers (asset class 00.13),

(iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),

(v) Automobiles, taxis (asset class 00.22),

(vi) Buses (asset class 00.23),
(vii) Light general purpose trucks (asset class 00.241),

(viii) Heavy general purpose trucks (asset class 00.242),

(ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25),

(x) Tractor units for use over-the-road (asset class 00.26),

(xi) Trailers and trailer-mounted containers (asset class 00.27),

(xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and

(xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

(3) Product classes. Except as provided in paragraphs (b)(4) and (5) of this section, or as provided by the Commissioner in published guidance of general applicability, property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 6-digit product class is referred to as the property's NAICS code.

(4) Modifications of NAICS product classes. The product classes of the NAICS Manual may be updated or otherwise modified from time to time as the manual is updated, effective on or after the date of the modification. The NAICS Manual generally is modified every five years, in years ending in a 2 or 7 (such as 2002, 2007, and 2012). The applicability date of the modified NAICS Manual is announced in the Federal

Register and generally is January 1 of the year the NAICS Manual is modified. Taxpayers may rely on these modifications as they become effective in structuring exchanges under this section. Taxpayers may rely on the previous NAICS Manual for transfers of property made by a taxpayer during the one-year period following the effective date of the modification. For transfers of property made by a taxpayer on or after January 1, 1997, and on or before January 1, 2003, the NAICS Manual of 1997 may be used for determining product classes of the exchanged property.

(5) Administrative procedures for revising general asset classes and product classes. The Commissioner may, through published guidance of general applicability, supplement, modify, clarify, or update the guidance relating to the classification of properties provided in this paragraph (b). (See Sec. 601.601(d)(2) of this chapter.) For example, the Commissioner may determine not to follow (in whole or in part) a general asset class for purposes of identifying property of like class, may determine not to follow (in whole or in part) any modification of product classes published in the NAICS Manual, or may determine that other properties not listed within the same or in any product class or general asset class nevertheless are of a like class. The Commissioner also may determine that two items of property that are listed in separate product classes or in product classes with a last digit of 9 are of a like class, or that an item of property that has a NAICS code is of a like class to an item of property that does not have a NAICS code.

(6) No inference outside of section 1031. The rules provided in this section concerning the use of general asset classes or product classes are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

(7) Examples. The application of this paragraph (b) may be illustrated by the following examples:

Example 1. Taxpayer A transfers a personal computer (asset class 00.12) to B in exchange for a printer (asset class 00.12). With respect to A, the properties exchanged are within the same General Asset Class and therefore are of a like class.

Example 2. Taxpayer C transfers an airplane (asset class 00.21) to D in exchange for a heavy general purpose truck (asset class 00.242). The properties exchanged are not of a like class because they are within different General Asset Classes. Because each of the properties is within a General Asset Class, the properties may not be classified within a Product Class. The airplane and heavy general purpose truck are also not of a like kind. Therefore, the exchange does not qualify for nonrecognition of gain or loss under section 1031.

Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (NAICS code 333210), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (NAICS code 333210). The personal computer and the printer are of a like class because they are within the same general asset class. The sanding machine and the lathe are of a like class because they are within the same product class (although neither property is within any of the general asset classes). The airplane and the heavy general purpose truck are neither within the same general asset class nor within the same product class, and are not of a like kind.

(8) Transition rule. Properties within the same product classes based on the 4-digit codes contained in Division D of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), will be treated as property of a like class for transfers of property made by taxpayers on or before May 19, 2005.

(c) Intangible personal property and nondepreciable personal property--

(1) General rule. An exchange of intangible personal property of nondepreciable personal property qualifies for nonrecognition of gain or loss under section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

(2) Goodwill and going concern value. The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

(3) Examples. The application of this paragraph (c) may be illustrated by the following examples:

Example 1. Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

Example 2. Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

(d) Effective date. Except as otherwise provided in this paragraph (d), this section applies to exchanges occurring on or after April 11, 1991. Paragraphs (b)(3) through (b)(6), Example 3 and Example 4 of paragraph (b)(7), and paragraph (b)(8) of this section apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply paragraphs (b)(3) through (b)(6), and Example 3 and Example 4 of paragraph (b)(7) of this section to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired.

Sec. 1.1031(b)-1
Receipt of other property or money in tax-free exchange.

(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money--

(1) In an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment,

(2) In an exchange described in section 1035(a) of insurance policies or annuity contracts,

(3) In an exchange described in section 1036(a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, or

(4) In an exchange described in section 1037(a) of obligations of the United States, issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), solely for other obligations issued under such Act, the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property, but the loss, if any, to the taxpayer from such an exchange will not be recognized under section 1031(c) to any extent.

(b) The application of this section may be illustrated by the following examples:

Example 1. A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

Example 2.

(a) B, who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In 1943, for $750 each, B purchased four $1,000 series E U.S. savings bonds bearing an issue date of March 1, 1943.

(b) On October 1, 1963, the redemption value of each such bond was $1,396, and the total redemption value of the four bonds was $5,584. On that date B submitted the four $1,000 series E bonds to the United States in a transaction in which one of such $1,000 bonds was reissued by issuing four $100 series E U.S. savings bonds bearing an issue date of March 1, 1943, and by considering six $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. The redemption value of each such $100 series E bond was $139.60 on October 1, 1963. Then, as part of the transaction, the six $100 series E bonds so considered to have been issued and the three $1,000 series E bonds were exchanged, in an exchange qualifying under section 1037(a), for five $1,000 series H U.S. savings bonds plus $25.60 in cash.

(c) The gain realized on the exchange qualifying under section 1037(a) is $2,325.60, determined as follows:

Amount realized:

Par value of five series H bonds	$5,000.00
Cash received	$25.60

Total realized	$5,025.60

Less: Adjusted basis of series E bonds surrendered in the exchange:

Three $1,000 series E bonds	$2,250.00
Six $100 series bonds at $75 each	$450.00

	$2,700.00
Gain realized	$2,325.60

(d) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange is recognized at the time of exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of Sec. 1.454-1.

(e) The gain on the four $100 series E bonds, determined by using $75 as a basis for each such bond, must be included in B's gross income for the taxable year in which such bonds are redeemed or disposed of, or reach final maturity, whichever is earlier.

Example 3.

(a) The facts are the same as in example (2), except that, as part of the transaction, the $1,000 series E bond is reissued by considering ten $100 series E bonds bearing an issue date of March 1, 1943, to have been issued. Six of the $100 series E bonds so considered to have been issued are surrendered to the United States as part of the exchange qualifying under section 1037(a) and the other four are immediately redeemed.

(b) Pursuant to section 1031(b), only $25.60 (the money received) of the total gain of $2,325.60 realized on the exchange qualifying under section 1037(a) is recognized at the time of the exchange and must be included in B's gross income for 1963. The $2,300 balance of the gain ($2,325.60 less $25.60) realized on such exchange must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of Sec. 1.454-1.

(c) The redemption on October 1, 1963, of the four $100 series E bonds considered to have been issued at such time results in gain of $258.40, which is then recognized and must be included in B's gross income for 1963. This gain of $258.40 is the difference between the $558.40 redemption value of such bonds on the date of the exchange and the $300 (4x$75) paid for such series E bonds in 1943.

Example 4. On November 1, 1963, C purchased for $91 a marketable U.S. bond which was originally issued at its par value of $100 under the Second Liberty Bond Act. On February 1, 1964, in an exchange qualifying under section 1037(a), C surrendered the bond to the United States for another marketable U.S. bond, which then had a fair market value of $92, and $1.85 in cash, $0.85 of which was interest. The $0.85 interest received is includible in gross income for the taxable year of the exchange, but the $2 gain ($93 less $91) realized on the exchange is recognized for such year under section 1031(b) to the extent of $1 (the money received). Under section 1031(d), C's basis in the bond received in exchange is $91 (his basis of $91 in the bond surrendered, reduced by the $1 money received and increased by the $1 gain recognized).

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as other property or money for the purposes of section 1031(b). Where, on an exchange described in section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See Sec. 1.1031(d)-2, examples (1) and (2).

Sec. 1.1031(b)-2
Safe harbor for qualified intermediaries.

(a) In the case of simultaneous transfers of like-kind properties
involving a qualified intermediary (as defined in Sec. 1.1031(k)-1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the transfer and receipt of property by the taxpayer is treated as an exchange.

(b) In the case of simultaneous exchanges of like-kind properties involving a qualified intermediary (as defined in Sec. 1.1031(k)-1(g)(4)(iii)), the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter.

(c) Paragraph (a) of this section applies to transfers of property made by taxpayers on or after June 10, 1991.

(d) Paragraph (b) of this section applies to transfers of property made by taxpayers on or after April 20, 1994. A taxpayer may choose to apply paragraph (b) of this section to transfers of property made on or after June 10, 1991.

Sec. 1.1031(c)-1
Nonrecognition of loss.

Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in section 1031(a), 1035(a), 1036(a), or 1037(a) where there is received in the exchange other property or money in ddition to property permitted to be received without recognition of gain or loss. See example (4) of paragraph (a)(3) of Sec. 1.1037-1 for an illustration of the application of this section in the case of an exchange of U.S. bligations described in section 1037(a).

Sec. 1.1031(d)-1
Property acquired upon a tax-free exchange.

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as

the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), section 1036(a), or section 1037(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragaph may be illustrated by the following example:

Example: A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $2,400 and $200 in cash. A realizes a gain of $100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	$2,500.00
Less: Amount of money received	$200.00

Difference	$2,300.00
Plus: Amount of gain recognized	$100.00

Basis of truck acquired by A	$2,400.00

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example: A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example: A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $10,000 and a fair market value of $11,000. The stock transferred has an adjusted basis of $4,000 and a fair market value of $2,000. The real estate acquired has a fair market value of $13,000. A is deemed to have received a $2,000 portion of the acquired real estate in exchange for the stock, since $2,000 is the fair market value of the stock at the time of the exchange. A $2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred	$10,000.00
Adjusted basis of stock transferred	$4,000.00

	$14,000.00
Less: Loss recognized on transfer of stock	$2,000.00

Basis of real estate acquired upon the exchange	$12,000.00

Sec. 1.1031(d)-1T
Coordination of section 1060 with section 1031 (temporary).

If the properties exchanged under section 1031 are part of a group of assets which constitute a trade or business under section 1060, the like-kind property and other property or money which are treated as transferred in exchange for the like-kind property shall be excluded from the allocation rules of section 1060. However, section 1060 shall apply to property which is not like-kind property or other property or money which is treated as transferred in exchange for the like-kind property. For application of the section 1060 allocation rules to property which is not part of the like-kind exchange, see Sec. 1.1060- 1(b), (c), and (d) Example 1 in Sec. 1.338-6(b), to which reference is made by Sec. 1.1060-1(c)(2).

Sec. 1.1031(d)-2
Treatment of assumption of liabilities.

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example 1. B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received	$600,000.00
Cash	$50,000.00
Liabilities subject to which old property was transferred	$150,000.00

Total consideration received	$800,000.00
Less: Adjusted basis of property transferred	$500,000.00

Gain realized	$300,000.00

Under section 1031(b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred	$500,000.00
Less: Amount of money received:	
Cash	$50,000.00
Amount of liabilities subject to which property was transferred	$150,000.00
	$200,000.00

Difference	$300,000.00
Plus: Amount of gain recognized upon the exchange	$200,000.00

Basis of property acquired upon the exchange	$500,000.00

Example 2.

(a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of $100,000, a fair market value of $220,000, but is subject to a mortgage of $80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of $175,000, a fair market value of $250,000, but is subject to a mortgage of $150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefore $40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of $120,000 on the exchange, computed as follows:

Value of property received	$250,000.00
Cash	$40,000.00
Liabilities subject to which old property was transferred	$80,000.00

Total consideration received	$370,000.00
Less: Adjusted basis of property transferred	$100,000.00
Liabilities to which new property is subject	$150,000.00

	$250,000.00
Gain realized	$120,000.00

For purposes of section 1031(b), the amount of other property or money received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a $150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as other property or money for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

Adjusted basis of property transferred	$100,000.00
Liabilities of new property is subject	$150,000.00

Total	$250,000.00
Less: Amount of money received:	
Cash	$40,000.00
Amount of liabilities subject to which property was transferred	$80,000.00

	$120,000.00
Difference	$130,000.00
Plus: Amount of gain recognized upon the exchange	$40,000.00

Basis of property acquired upon the exchange	$170,000.00

(c) E realizes a gain of $75,000 on the exchange, computed as follows:

Value of property received	$220,000.00
Liabilities subject to which old property was transferred	$150,000.00

Total consideration received	$370,000.00
Less: Adjusted basis of property transferred:	$175,000.00
Cash	$40,000.00
Liabilities to which new property is subject	$80,000.00

	$295,000.00
Gain realized	$75,000.00

For purposes of section 1031(b), the amount of other property or money received by E is $30,000. (Consideration received by E in the form of a transfer subject to a liability of $150,000 is offset by consideration given in the form of a receipt of property subject to an $80,000 liability and by the $40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), $30,000 of the $75,000 gain is recognized. The basis of the apartment house acquired by E is $175,000, computed as follows:

Adjusted basis of property transferred	$175,000.00
Cash	$40,000.00
Liabilities to which new property is subject	$80,000.00

Total	$295,000.00
Less: Amount of money received: Amount of liabilities subject to which property was transferred	$150,000.00

	$150,000.00

Difference	$145,000.00
Plus: Amount of gain recognized upon the exchange	$30,000.00
Basis of property acquired upon the exchange	$175,000.00

Sec. 1.1031(e)-1
Exchange of livestock of different sexes.

Section 1031(e) provides that livestock of different sexes are not property of like kind. Section 1031(e) and this section are applicable to taxable years to which the Internal Revenue Code of 1954 applies.

Sec. 1.1031(j)-1
Exchanges of multiple properties.

(a) Introduction--(1) Overview. As a general rule, the application of section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group. Paragraph (b) of this section provides rules for computing the amount of gain recognized in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031. Paragraph (c) of this section provides rules for computing the basis of properties received in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031.

(2) General approach.

(i) In general, the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received by the taxpayer in the exchange into exchange groups in the manner described in paragraph (b)(2) of this section. The separation of the properties transferred and the properties received in the exchange into exchange groups involves matching up properties of a like kind of like class to the extent possible. Next, all liabilities assumed by the taxpayer as part of the transaction are offset by all liabilities of which the taxpayer is relieved as part of the transaction, with the excess liabilities assumed or relieved allocated in accordance with paragraph (b)(2)(ii) of this section. Then, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the amount of gain recognized in the exchange. See Sec. 1.1031(b)-1 and 1.1031(c)-1. Finally, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the basis of the properties received in the exchange. See Sec. Sec. 1.1031(d)-1 and 1.1031(d)-2.

(ii) For purposes of this section, the exchanges are assumed to be made at arms' length, so that the aggregate fair market value of the property received in the exchange equals the aggregate fair market value of the property transferred. Thus, the amount realized with respect to the properties transferred in each exchange group is assumed to equal their aggregate fair market value.

(b) Computation of gain recognized—

(1) In general. In computing the amount of gain recognized in an exchange of multiple properties, the fair market value must be determined for each property transferred and for each property received by the taxpayer in the exchange. In addition, the adjusted basis must be determined for each property transferred by the taxpayer in the exchange.

(2) Exchange groups and residual group. The properties transferred and the properties received by the taxpayer in the exchange are separated into exchange groups and a residual group to the extent provided in this paragraph (b)(2).

(i) Exchange groups. Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or like class. If a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Property eligible for inclusion within an exchange group does not include money or property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action). For example, an exchange group may consist of all exchanged properties that are within the same General Asset Class or within the same Product Class (as defined in Sec. 1.1031(a)-2(b)). Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

(ii) Treatment of liabilities.

(A) All liabilities assumed by the taxpayer as part of the exchange are offset against all liabilities of which the taxpayer is relieved as part of the exchange, regardless of whether the liabilities are recourse or nonrecourse and regardless of whether the liabilities are secured by or otherwise relate to specific property transferred or received as part of the exchange. See Sec. Sec. 1.1031 (b)-1(c) and 1.1031(d)-2. For purposes of this section, liabilities assumed by the taxpayer as part of the exchange consist of liabilities of the other party to the exchange assumed by the taxpayer and liabilities subject to which the other party's property is transferred in the exchange. Similarly, liabilities of which the taxpayer is relieved as part of the exchange consist of liabilities of the taxpayer assumed by the other party to the exchange and liabilities subject to which the taxpayer's property is transferred.

(B) If there are excess liabilities assumed by the taxpayer as part of the exchange (i.e., the amount of liabilities assumed by the taxpayer exceeds the amount of liabilities of which the taxpayer is relieved), the excess is allocated among the exchange groups (but not to the residual group) in proportion to the aggregate fair market value of the properties received by the taxpayer in the exchange groups. The amount of excess liabilities assumed by the taxpayer that are allocated to each exchange group may not exceed the aggregate fair market value of the properties received in the exchange group.

(C) If there are excess liabilities of which the taxpayer is relieved as part of the exchange (i.e., the amount of liabilities of which the taxpayer is relieved exceeds the amount of liabilities assumed by the taxpayer), the excess is treated as a Class I asset for purposes of making allocations to the residual group under paragraph (b)(2)(iii) of this section.

(D) Paragraphs (b)(2)(ii) (A), (B), and (C) of this section are applied in the same manner even if section 1031 and this section apply to only a portion of a larger transaction (such as a transaction described in section 1060(c) and Sec. 1.1060-1T(b)). In that event, the amount of excess liabilities assumed by the taxpayer or the amount of excess liabilities of which the taxpayer is relieved is determined based on all liabilities assumed by the taxpayer and all liabilities of which the taxpayer is relieve as part of the larger transaction.

(iii) Residual group. If the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups (taking liabilities into account in the manner described in paragraph (b)(2)(ii) of this section), a residual group is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to that difference. The residual group consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both. For this purpose, other property includes property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action), property transferred that is not of a like kind or like class with any property received, and property received that is not of a like kind or like class with any property transferred. The money and properties that are allocated to the residual group are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, and then from Class IV assets. The terms Class I assets, Class II assets, Class III assets, and Class IV assets have the same meanings as in Sec. 1.338-6(b), to which reference is made by Sec. 1.1060-1(c)(2). Within each Class, taxpayers may choose which properties are allocated to the residual group.

(iv) Exchange group surplus and deficiency. For each of the exchange groups described in this section, an ``exchange group surplus'' or ``exchange group deficiency,'' if any, must be determined. An exchange group surplus is the excess of the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group), in an exchange group over the aggregate fair market value of the properties transferred in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in that exchange group.

(3) Amount of gain recognized.

(i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031 (a) and (c). The total amount of gain recognized under section 1031 in the exchange is the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.

(ii) The amount of gain or loss realized and recognized with respect to properties transferred by the taxpayer that are not within any exchange group or the residual group is determined under section 1001 and other applicable provisions of the Code, with proper adjustments made for all liabilities not allocated to the exchange groups or the residual group.

(c) Computation of basis of properties received. In an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031 and this section, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

(d) Examples. The application of this section may be illustrated by the following examples:

Example 1.

(i) K exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by K for productive use in its business, with W for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by K for productive use in its business. K's adjusted basis and the fair market value of the exchanged properties are as follows:

	Adjusted basis	Fair market value
Computer A	$375	$1,000
Automobile A	$1,500	$4,000
Printer B	---	$2,050
Automobile B	---	$2,950

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to K, has an exchange group surplus of $1050 because the fair market value of printer B ($2050) exceeds the fair market value of computer A ($1000) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to K, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(iii) K recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($0), or $0.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($1500), or $2500. The amount of gain recognized is the lesser of the gain realized ($2500) and the exchange group deficiency ($1050), or $1050.

(iv) The total amount of gain recognized by K in the exchange is the sum of the gains recognized with respect to both exchange groups ($0 + $1050), or $1050.

(v) The bases of the property received by K in the exchange, printer B and automobile B, are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within the exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1425. Because printer B was the only property received within the first exchange group, the entire basis of $1425 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($1500), increased by the amount of gain recognized with respect to that exchange group ($1050), decreased by the amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1500. Because automobile B was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile B.

Example 2.

(i) F exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by F for productive use in its business, with G for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by F for productive use in its business, and corporate stock and $500 cash. The adjusted basis and fair market value of the properties are as follows:

	Adjusted basis	Fair market value
Computer A	$375	$1,000
Automobile A	$3,500	$4,000
Printer B	---	$800
Automobile B	---	$2,950
Corporate stock	---	$750
Cash	---	$500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $200 because the fair market value of computer A ($1000) exceeds the fair market value of printer B ($800) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of $1050 because the fair market value of automobile A ($4000) exceeds the fair market value of automobile B ($2950) by that amount.

(C) Because the aggregate fair market value of the properties transferred by F in the exchange groups ($5,000) exceeds the aggregate fair market value of the properties received by F in the exchange groups ($3750) by $1250, there is a residual group in that amount consisting of the $500 cash and the $750 worth of corporate stock.

(iii) F recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1000) over its adjusted basis ($375), or $625. The amount of gain recognized is the lesser of the gain realized ($625) and the exchange group deficiency ($200), or $200.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($4000) over its adjusted basis ($3500), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($1050), or $500.

(C) No property transferred by F was allocated to the residual group. Therefore, F does not recognize gain or loss with respect to the residual group.

(iv) The total amount of gain recognized by F in the exchange is the sum of the gains recognized with respect to both exchange groups ($200 + $500), or $700.

(v) The bases of the properties received by F in the exchange (printer B, automobile B, and the corporate stock) are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($375), increased by the amount of gain recognized with respect to that exchange group ($200), decreased by the amount of the exchange group deficiency ($200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $375. Because printer B was the only property received within the first exchange group, the entire basis of $375 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($3500), increased by the amount of gain recognized with respect to that exchange group ($500), decreased by the amount of the exchange group deficiency ($1050), and increased by the amount of excess liabilites assumed allocated to that exchange group ($0), or $2950. Because automobile B was the only property received within the second exchange group, the entire basis of $2950 is allocated to automobile B.

(C) The basis of the property received within the residual group (the corporate stock) is equal to its fair market value or $750. Cash of $500 is also received within the residual group.

Example 3.

(i) J and H enter into an exchange of the following properties. All of the property (except for the inventory) transferred by J was held for productive use in J's business. All of the property received by J will be held by J for productive use in its business.

J Transfers:

Property	Adjusted basis	Fair market value
Computer A	$1,500	$5,000
Computer B	$500	$3,000
Printer C	$2,000	$1,500
Real Estate D	$1,200	$2,000
Real Estate E	$0	$1,800
Scraper F	$3,300	$2,500
Inventory	$1,000	$1,700
Total	$9,500	$17,500

H Transfers:

Property	Fair market value
Computer Z	$4,500
Printer Y	$2,500
Real Estate X	$1,000
Real Estate W	$4,000
Grader V	$2,000
Truck T	$1,700
Cash	$1,800
Total	$17,500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A, computer B, printer C, computer Z, and printer Y (all are within the same General Asset Class) and, as to J, has an exchange group deficiency of $2500 (($5000 + $3000 + $1500) - ($4500 + $2500)).

(B) The second exchange group consists of real estate D, E, X and W (all are of a like kind) and, as to J, has an exchange group surplus of $1200 (($1000 + $4000) - ($2000 + $1800)).

(C) The third exchange group consists of scraper F and grader V (both are within the same Product Class (NAICS code 333120)) and, as to J, has an exchange group deficiency of $500 ($2500 - $2000).

(D) Because the aggregate fair market value of the properties transferred by J in the exchange groups ($15,800) exceeds the aggregate fair market value of the properties received by J in the exchange groups ($14,000) by $1800, there is a residual group in that amount consisting of the $1800 cash (a Class I asset).

(E) The transaction also includes a taxable exchange of inventory (which is property described in section 1031 (a)(2)) for truck T (which is not of a like kind or like class to any property transferred in the exchange).

(iii) J recognizes gain on the transaction as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($9500) over the aggregate adjusted basis ($4000), or $5500. The amount of gain recognized is the lesser of the gain realized ($5500) and the exchange group deficiency ($2500), or $2500.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group ($3800) over the aggregate adjusted basis ($1200), or $2600. The amount of gain recognized is the lesser of the gain realized ($2600) and the exchange group deficiency ($0), or $0.

(C) With respect to the third exchange group, a loss is realized in the amount of $800 because the fair market value of the property transferred in the exchange group ($2500) is less than its adjusted basis ($3300). Although a loss of $800 was realized, under section 1031 (a) and (c) losses are not recognized.

(D) No property transferred by J was allocated to the residual group. Therefore, J does not recognize gain or loss with respect to the residual group.

(E) With respect to the taxable exchange of inventory for truck T, gain of $700 is realized and recognized by J (amount realized of $1700 (the fair market value of truck T) less the adjusted basis of the inventory ($1000)).

(iv) The total amount of gain recognized by J in the transaction is the sum of the gains recognized under section 1031 with respect to each exchange group ($2500 + $0 + $0) and any gain recognized outside of section 1031 ($700), or $3200.

(v) The bases of the property received by J in the exchange are determined in the following manner:

(A) The aggregate basis of the properties received in the first exchange group is the adjusted basis of the properties transferred within that exchange group ($4000), increased by the amount of gain recognized with respect to that exchange group ($2500), decreased by the amount of the exchange group deficiency ($2500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $4000. This $4000 of basis is allocated proportionately among the assets received within the first exchange group in accordance with their fair market values: Computer Z's basis is $2571 ($4000 x $4500/ $7000); printer Y's basis is $1429 ($4000 x $2500/$7000).

(B) The aggregate basis of the properties received in the second exchange group is the adjusted basis of the properties transferred within that exchange group ($1200), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1200), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2400. This $2400 of basis is allocated proportionately among the assets received within the second exchange group in accordance with their fair market values: Real estate X's basis is $480 ($2400 x $1000/$5000); real estate W's basis is $1920 ($2400 x $4000/$5000).

(C) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($3300), increased by the amount of gain recognized with respect to that exchange group ($0), decreased by the amount of the exchange group deficiency ($500), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2800. Because grader V was the only property received within the third exchange group, the entire basis of $2800 is allocated to grader V.

(D) Cash of $1800 is received within the residual group.

(E) The basis of the property received in the taxable exchange (truck T) is equal to its cost of $1700.

Example 4.

(i) B exchanges computer A (asset class 00.12), automobile A (asset class 00.22) and truck A (asset class 00.241), with C for computer R (asset class 00.12), automobile R (asset class 00.22), truck R (asset class 00.241) and $400 cash. All properties transferred by either B or C were held for productive use in the respective transferor's business. Similarly, all properties to be received by either B or C will be held for productive use in the respective recipient's business. Automobile A, automobile R and truck R are each secured by a nonrecourse liability and are transferred subject to such liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

B transfers:

	Adjusted basis	Fair market value	Liability
Computer A	$800	$1,500	$0
Automobile A	$900	$2,500	$500
Truck A	$700	$2,000	$0

C transfers:

	Adjusted basis	Fair market value	Liability
Computer R	$1,100	$1,600	$0
Automobile R	$2,100	$3,100	$750
Truck R	$600	$1,400	$250
Cash	--	$400	--

(ii) The tax treatment to B is as follows:

(A)(1) The first exchange group consists of computers A and R (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles A and R (both are within the same General Asset Class).

(3) The third exchange group consists of trucks A and R (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by B ($1000) are offset by all liabilities of which B is relieved ($500), resulting in excess liabilities assumed of $500. The excess liabilities assumed of $500 is allocated among the exchange groups in proportion to the fair market value of the properties received by B in the exchange groups as follows:

(1) $131 of excess liabilities assumed ($500 x $1600/$6100) is allocated to the first exchange group. The first exchange group has an exchange group deficiency of $31 because the fair market value of computer A ($1500) exceeds the fair market value of computer R less the excess liabilities assumed allocated to the exchange group ($1600-$131) by that amount.

(2) $254 of excess liabilities assumed ($500 x $3100/$6100) is allocated to the second exchange group. The second exchange group has an exchange group surplus of $346 because the fair market value of automobile R less the excess liabilities assumed allocated to the exchange group ($3100-$254) exceeds the fair market value of automobile A ($2500) by that amount.

(3) $115 of excess liabilities assumed ($500 x $1400/$6100) is allocated to the third exchange group. The third exchange group has an exchange group deficiency of $715 because the fair market value of truck A ($2000) exceeds the fair market value of truck R less the excess liabilities assumed allocated to the exchange group ($1400-$115) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred in all of the exchange groups, $6000, and the aggregate fair market value of the properties received in all of the exchange groups (taking excess liabilities assumed into account), $5600, is $400. Therefore there is a residual group in that amount consisting of $400 cash received.

(C) B recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A ($1500) over its adjusted basis ($800), or $700. The amount of gain recognized is the lesser of the gain realized ($700) and the exchange group deficiency ($31), or $31.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A ($2500) over its adjusted basis ($900), or $1600. The amount of gain recognized is the lesser of the gain realized ($1600) and the exchange group deficiency ($0), or $0.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck A ($2000) over its adjusted basis ($700), or $1300. The amount of gain recognized is the lesser of gain realized ($1300) and the exchange group deficiency ($715), or $715.

(4) No property transferred by B was allocated to the residual group. Therefore, B does not recognize gain or loss with respect to the residual group.

(D) The total amount of gain recognized by B in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($31 + $0 +$715), or $746.

(E) the bases of the property received by B in the exchange (computer R, automobile R, and truck R) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($800), increased by the amount of gain recognized with respect to that exchange group ($31), decreased by the amount of the exchange group deficiency ($31), and increased by the amount of excess liabilities assumed allocated to that exchange group ($131), or $931. Because computer R was the only property received within the first exchange group, the entire basis of $931 is allocated to computer R.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($900), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($346), and increased by the amount of excess liabilities assumed allocated to that exchange group ($254), or $1500. Because automobile R was the only property received within the second exchange group, the entire basis of $1500 is allocated to automobile R.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($700), increased by the amount of gain recognized with respect to that exchange group ($715), decreased by the amount of the exchange group deficiency ($715), and increased by the amount of excess liabilities assumed allocated to that exchange group ($115), or $815. Because truck R was the only property received within the third exchange group, the entire basis of $815 is allocated to truck R.

(F) Cash of $400 is also received by B.

(iii) The tax treatment to C is as follows:

(A) (1) The first exchange group consists of computers R and A (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles R and A (both are within the same General Asset Class).

(3) The third exchange group consists of trucks R and A (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities of which C is relieved ($1000) are offset by all liabilities assumed by C ($500), resulting in excess liabilities relieved of $500. This excess liabilities relieved is treated as cash received by C.

(1) The first exchange group has an exchange group deficiency of $100 because the fair market value of computer R ($1600) exceeds the fair market value of computer A ($1500) by that amount.

(2) The second exchange group has an exchange group deficiency of $600 because the fair market value of automobile R ($3100) exceeds the fair market value of automobile A ($2500) by that amount.

(3) The third exchange group has an exchange group surplus of $600 because the fair market value of truck A ($2000) exceeds the fair market value of truck R ($1400) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred by C in all of the exchange groups, $6100, and the aggregate fair market value of the properties received by C in all of the exchange groups, $6000, is $100. Therefore, there is a residual group in that amount, consisting of excess liabilities relieved of $100, which is treated as cash received by C.

(5) The $400 cash paid by C and $400 of the excess liabilities relieved which is treated as cash received by C are not within the exchange groups of the residual group.

(C) C recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer R ($1600) over its adjusted basis ($1100), or $500. The amount of gain recognized is the lesser of the gain realized ($500) and the exchange group deficiency ($100), or $100.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile R ($3100) over its adjusted basis ($2100), or $1000. The amount of gain recognized is the lesser of the gain realized ($1000) and the exchange group deficiency ($600), or $600.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck R ($1400) over its adjusted basis ($600), or $800. The amount of gain recognized is the lesser of gain realized ($800) and the exchange group deficiency ($0), or $0.

(4) No property transferred by C was allocated to the residual group. Therefore, C does not recognize any gain with respect to the residual group.

(D) The total amount of gain recognized by C in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group ($100+$600+$0), or $700.

(E) The bases of the properties received by C in the exchange (computer A, automobile A, and truck A) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group ($1100), increased by the amount of gain recognized with respect to that exchange group ($100), decreased by the amount of the exchange group deficiency ($100), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $1100. Because computer A was the only property received within the first exchange group, the entire basis of $1100 is allocated to computer A.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group ($2100), increased by the amount of gain recognized with respect to that exchange group ($600), decreased by the amount of the exchange group deficiency ($600), and increased by the amount of excess liabilities assumed allocated to that exchange group ($0), or $2100. Because automobile A was the only property received within the second exchange group, the entire basis of $2100 is allocated to automobile A.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group ($600), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($600), and increased by the amount of excess liabilities assumed allocated to that exchange

group ($0), or $1200. Because truck A was the only property received within the third exchange group, the entire basis of $1200 is allocated to truck A.

Example 5.

(i) U exchanges real estate A, real estate B, and grader A (NAICS code 333120) with V for real estate R and railroad car R (General Asset Class 00.25). All properties transferred by either U or V were held for productive use in the respective transferor's business. Similarly, all properties to be received by either U or V will be held for productive use in the respective recipient's business. Real estate R is secured by a recourse liability and is transferred subject to that liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

U Transfers

	Adjusted basis	Fair market value	Liability
Real Estate A	$2,000	$5,000	--
Real Estate B	$8,000	$13,500	--
Grader A	$500	$2,000	--

V Transfers

	Adjusted basis	Fair market value	Liability
Real Estate R	$20,000	$26,500	$7,000
Railroad car R	$1,200	$1,000	--

(ii) The tax treatment to U is as follows:

(A) The exchange group consists of real estate A, real estate B, and real estate R.

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by U ($7000) are excess liabilities assumed. The excess liabilities assumed of $7000 is allocated to the exchange group.

(1) The exchange group has an exchange group surplus of $1000 because the fair market value of real estate R less the excess liabilities assumed allocated to the exchange group ($26,500-$7000) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties received in the exchange group (taking excess liabilities assumed into account), $19,500, and the aggregate fair market value of the properties transferred in the exchange group, $18,500, is $1000. Therefore, there is a residual group in that amount consisting of $1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of the 50 percent portion of grader A not allocated to the residual group (which is not of a like kind or like class to any property received by U in the exchange) for railroad car R (which is not of a like kind or like class to any property transferred by U in the exchange).

(C) U recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the aggregate fair market value of real estate A and B ($18,500) over the aggregate adjusted basis ($10,000), or $8500.
The amount of the gain recognized is the lesser of the gain realized ($8500) and the exchange group deficiency ($0), or $0.

(2) With respect to the residual group, the amount of gain realized and recognized is the excess of the fair market value of the 50 percent portion of grader A that is allocated to the residual group ($1000) over its adjusted basis ($250), or $750.

(3) With respect to the taxable exchange of the 50 percent portion of grader A not allocated to the residual group for railroad car R, gain of $750 is realized and recognized by U (amount realized of $1000 (the fair market value of railroad car R) less the adjusted basis of the 50 percent portion of grader A not allocated to the residual group ($250)).

(D) The total amount of gain recognized by U in the transaction is the sum of the gain recognized under section 1031 with respect to the exchange group ($0), any gain recognized with respect to the residual group ($750), and any gain recognized with respect to property transferred that is not in the exchange group or the residual group ($750), or $1500.

(E) The bases of the property received by U in the exchange (real estate R and railroad car R) are determined in the following manner:

(1) The basis of the property received in the exchange group is the aggregate adjusted basis of the property transferred within that exchange group ($10,000), increased by the amount of gain recognized with respect to that exchange group ($0), increased by the amount of the exchange group surplus ($1000), and increased by the amount of excess liabilities assumed allocated to that exchange

group ($7000), or $18,000. Because real estate R is the only property received within the exchange group, the entire basis of $18,000 is allocated to real estate R.

(2) The basis of railroad car R is equal to its cost of $1000.

(iii) The tax treatment to V is as follows:

(A) The exchange group consists of real estate R, real estate A, and real estate B.

(B) Under paragraph (b)(2)(ii) of this section, the liabilities of which V is relieved ($7000) results in excess liabilities relieved of $7000 and is treated as cash received by V.

(1) The exchange group has an exchange group deficiency of $8000 because the fair market value of real estate R ($26,500) exceeds the aggregate fair market value of real estate A and B ($18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties transferred by V in the exchange group, $26,500, and the aggregate fair market value of the properties received by V in the exchange group, $18,500, is $8000. Therefore, there is a residual group in that amount, consisting of the excess liabilities relieved of $7000, which is treated as cash received by V, and $1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of railroad car R (which is not of a like kind or like class to any property received by V in the exchange) for the 50 percent portion of grader A (which is not of a like kind or like class to any property transferred by V in the exchange) not allocated to the residual group.

(C) V recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the fair market value of real estate R ($26,500) over its adjusted basis ($20,000), or $6500. The amount of the gain recognized is the lesser of the gain realized ($6500) and the exchange group deficiency ($8000), or $6500.

(2) No property transferred by V was allocated to the residual group. Therefore, V does not recognize gain or loss with respect to the residual group.

(3) With respect to the taxable exchange of railroad car R for the 50 percent portion of grader A not allocated to the exchange group or the residual group, a loss is realized and recognized in the amount of $200 (the excess of the $1200 adjusted basis of railroad car R over the amount realized of $1000 (fair market value of the 50 percent portion of grader A)).

(D) The basis of the property received by V in the exchange (real estate A, real estate B, and grader A) are determined in the following manner:

(1) The basis of the property received in the exchange group is the adjusted basis of the property transferred within that exchange group ($20,000), increased by the amount of gain recognized with respect to that exchange group ($6500), and decreased by the amount of the exchange group deficiency ($8000), or $18,500. This $18,500 of basis is allocated proportionately among the assets received within the exchange group in accordance with their fair market values: real estate A's basis is $5000 ($18,500 x $5000/$18,500); real estate B's basis is $13,500 ($18,500 x $13,500/$18,500).

(2) The basis of grader A is $2000.

(e) Effective date. Section 1.1031 (j)-1 is effective for exchanges occurring on or after April 11, 1991.

Sec. 1.1031(k)-1
Treatment of deferred exchanges.

(a) Overview. This section provides rules for the application of section 1031 and the regulations thereunder in the case of a ``deferred exchange.'' For purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the ``relinquished property'') and subsequently receives property to be held either for productive use in a trade or business or for investment (the ``replacement property''). In the case of a deferred exchange, if the requirements set forth in paragraphs (b), (c), and (d) of this section (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property. In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of this section are satisfied. The transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See Sec. 1.1031(a)-1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. For purposes of this section, property which does not meet the requirements of section 1031(a) (whether by being described in section 1031(a)(2) or otherwise) is referred to as ``other property.'' For rules regarding actual and constructive receipt, and safe harbors therefrom, see paragraphs (f) and (g), respectively, of this section. For rules regarding the determination of gain or loss recognized and the basis of property received in a deferred exchange, see paragraph (j) of this section.

(b) Identification and receipt requirements—

(1) In general. In the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property if—

(i) The replacement property is not ``identified'' before the end of the ``identification period,'' or

(ii) The identified replacement property is not received before the end of the ``exchange period.''

(2) Identification period and exchange period.

(i) The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

(ii) The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return of the tax imposed by chapter 1 of subtitle A of the Code for the taxable year in which the transfer of the relinquished property occurs.

(iii) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred.

(iv) For purposes of this paragraph (b)(2), property is transferred when the property is disposed of within the meaning of section 1001(a).

(3) Example. This paragraph (b) may be illustrated by the following example.

Example: (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992.

(ii) The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X.

The exchange period ends at midnight on March 15, 1993, the due date for M's Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

(c) Identification of replacement property before the end of the identification period—

(1) In general. For purposes of paragraph (b)(1)(i) of this section (relating to the identification requirement), replacement property is identified before the end of the identification period only if the requirements of this paragraph (c) are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

(2) Manner of identifying replacement property. Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either—

(i) The person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person as defined in paragraph (k) of this section); or

(ii) Any other person involved in the exchange other than the taxpayer or a disqualified person (as defined in paragraph (k) of this section). Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements of this paragraph (c)(2).

(3) Description of replacement property. Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambigously described if it is described by a specific make, model, and year.

(4) Alternative and multiple properties.

(i) The taxpayer may identify more than one replacement property. Regardless of the number of relinguished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is—

(A) Three properties without regard to the fair market values of the properties (the ``3-property rule''), or

(B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinguished properties as of the date the relinguished properties were transferred by the taxpayer (the ``200-percent rule'').

(ii) If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted by paragraph (c)(4)(i) of this section, the taxpayer is treated as if no replacement property had been identified. The preceding sentence will not apply, however, and an identification satisfying the requirements of paragraph (c)(4)(i) of this section will be considered made, with respect to—

(A) Any replacement property received by the taxpayer before the end of the identification period, and

(B) Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market vlaue of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the ``95-percent rule''). For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period.

(iii) For purposes of applying the 3-property rule, the 200-percent rule, and the 95-percent rule, all identifications of replacement property, other than identifications of replacement property that have been revoked in the manner provided in paragraph (c)(6) of this section, are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of $100,000 to C and B receives like-kind property Y with a fair market value of $50,000 before the end of the identification period, under paragraph (c)(1) of this section, property Y is treated as identified by reason of being received before the end of the identification period. Thus, under paragraph (c)(4)(i) of this section, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed $150,000.

(5) Incidental property disregarded.

(i) Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if—

(A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and

(B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

(ii) This paragraph (c)(5) may be illustrated by the following examples.

Example 1. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of $10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed $1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire, and tool kit are all considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.

Example 2. For purposes of paragraph (c) of this section, furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $1,000,000, if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed $150,000. For purposes of the 3-property rule, the apartment building, furniture, laundry machines, and other personal property are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the apartment building, furniture, laundry machines, and other personal property are all considered to be unambiguously described if the legal description, street address, or distinguishable name of the apartment building is specified, even if no reference is made to the furniture, laundry machines, and other personal property.

(6) Revocation of identification. An identification of replacement property may be revoked at any time before the end of the identification period. An identification of replacement property is revoked only if the revocation is made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or othewise sent before the end of the identification period to the person to whom the identification of the replacement property was sent. An identification of replacement property that is made in a written agreement for the exchange of properties is treated as revoked only if the revocation is made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or othewise sent before the end of the identification period to all of the parties to the agreement.

(7) Examples. This paragraph (c) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. No replacement property is identified in the agreement. When subsequently identified, the replacement property is described by legal description and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold the replacement property received for investment.

Example 1. (i) On July 2, 1991, B identifies real property E as replacement property by designating real property E as replacement property in a written document signed by B and personally delivered to C.

(ii) Because the identification was made after the end of the identification period, pursuant to paragraph (b)(1)(i) of this section (relating to the identification requirement), real property E is treated as property which is not of a like kind to real property X.

Example 2. (i) C is a corporation of which 20 percent of the outstanding stock is owned by B. On July 1, 1991, B identifies real property F as replacement property by designating real property F as replacement property in a written document signed by B and mailed to C.

(ii) Because C is the person obligated to transfer the replacement property to B, real property F is identified before the end of the identification period. The fact that C is a ``disqualified person'' as defined in paragraph (k) of this section does not change this result.

(iii) Real property F would also have been treated as identified before the end of the identification period if, instead of sending the identification to C, B had designated real property F as replacement property in a written agreement for the exchange of properties signed by all parties thereto on or before July 1, 1991.

Example 3. (i) On June 3, 1991, B identifies the replacement property as ``unimproved land located in Hood County with a fair market value not to exceed $100,000.'' The designation is made in a written document signed by B and personally delivered to C. On July 8, 1991, B and C agree that real property G is the property described in the June 3, 1991 document.

(ii) Because real property G was not unambiguously described before the end of the identification period, no replacement property is identified before the end of the identification period.

Example 4. (i) On June 28, 1991, B identifies real properties H, J, and K as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by August 1, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties H, J, and K are $75,000, $100,000, and $125,000, respectively.

(ii) Because B did not identify more than three properties as replacement properties, the requirements of the 3-property rule are satisfied, and real properties H, J, and K are all identified before the end of the identification period.

Example 5. (i) On May 17, 1991, B identifies real properties L, M, N, and P as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by July 2, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties L, M, N, and P are $30,000, $40,000, $50,000, and $60,000, respectively.

(ii) Although B identified more than three properties as replacement properties, the aggregate fair market value of the identified properties as of the end of the identification period ($180,000) did not exceed 200 percent of the aggregate fair market value of real property X (200% x $100,000 = $200,000). Therefore, the requirements of the 200-percent rule are satisfied, and real properties L, M, N, and P are all identified before the end of the identification period.

Example 6. (i) On June 21, 1991, B identifies real properties Q, R, and S as replacement properties by designating these properties as replacement properties in a written document signed by B and mailed to C. On June 24, 1991, B identifies real properties T and U as replacement properties in a written document signed by B and mailed to C. On June 28, 1991, B revokes the identification of real properties Q and R in a written document signed by B and personally delivered to C.

(ii) B has revoked the identification of real properties Q and R in the manner provided by paragraph (c)(6) of this section. Identifications of replacement property that have been revoked in the manner provided by paragraph (c)(6) of this section are not taken into account for purposes of applying the 3-property rule. Thus, as of June 28, 1991, B has identified only replacement properties S, T, and U for purposes of the 3-property rule. Because B did not identify more than three properties as replacement properties for purposes of the 3-property rule, the requirements of that rule are satisfied, and real properties S, T, and U are all identified before the end of the identification period.

Example 7. (i) On May 20, 1991, B identifies real properties V and W as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. On June 4, 1991, B identifies real properties Y and Z as replacement properties in the same manner. On June 5, 1991, B telephones C and orally revokes the identification of real properties V and W. As of July 1, 1991, the fair market values of real properties V, W, Y, and Z are $50,000, $70,000, $90,000, and $100,000, respectively. On July 31, 1991, C purchases real property Y and Z and transfers them to B.

(ii) Pursuant to paragraph (c)(6) of this section (relating to revocation of identification), the oral revocation of the identification of real properties V and W is invalid. Thus, the identification of real properties V and W is taken into account for purposes of determining whether the requirements of paragraph (c)(4) of this section (relating to the identification of alternative and multiple properties) are satisfied. Because B identified more than three properties and the aggregate fair market value of the identified properties as of the end of the identification period ($310,000) exceeds 200 percent of the fair market value of real property X (200% x $100,000 = $200,000), the requirements of paragraph (c)(4) of this section are not satisfied, and B is treated as if B did not identify any replacement property.

(d) Receipt of identified replacement property—

(1) In general. For purposes of paragraph (b)(1)(ii) of this section (relating to the receipt requirement), the identified replacement property is received before the end of the exchange period only if the requriements of this paragraph (d) are satisfied with respect to the replacement property. In the case of a deferred exchange, the identified replacement property is received before the end of the exchange period if—

(i) The taxpayer receives the replacement property before the end of the exchange period, and

(ii) The replacement property received is substantially the same property as identified.

If the taxpayer has identified more than one replacement property, section 1031(a)(3)(B) and this paragraph (d) are applied separately to each replacement property.

(2) Examples. This paragraph (d) may be illustrated by the following examples. The following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified in a manner that satisfies paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) In the agreement, B identifies real properties J, K, and L as replacement properties. The agreement provides that by July 26, 1991, B will orally inform C which of the properties C is to transfer to B.

(ii) As of July 1, 1991, the fair market values of real properties J, K, and L are $75,000, $100,000, and $125,000, respectively. On July 26, 1991, B instructs C to acquire real property K. On October 31, 1991, C purchases real property K for $100,000 and transfers the property to B.

(iii) Because real property K was identified before the end of the identification period and was received before the end of the exchange period, the identification and receipt requirements of section 1031(a)(3) and this section are satisfied with respect to real property K.

Example 2. (i) In the agreement, B identifies real property P as replacement property. Real property P consists of two acres of unimproved land. On October 15, 1991, the owner of real property P erects a fence on the property. On November 1, 1991, C purchases real property P and transfers it to B.

(ii) The erection of the fence on real property P subsequent to its identification did not alter the basic nature or character of real property P as unimproved land. B is considered to have received substantially the same property as identified.

Example 3. (i) In the agreement, B identifies real property Q as replacement property. Real property Q consists of a barn on two acres of land and has a fair market value of $250,000 ($187,500 for the barn and underlying land and $87,500 for the remaining land). As of July 26, 1991, real property Q remains unchanged and has a fair market value of $250,000. On that date, at B's direction, C purchases the barn and underlying land for $187,500 and transfers it to B, and B pays $87,500 to C.

(ii) The barn and underlying land differ in basic nature or character from real property Q as a whole, B is not considered to have received substantially the same property as identified.

Example 4. (i) In the agreement, B identifies real property R as replacement property. Real property R consists of two acres of unimproved land and has a fair market value of $250,000. As of October 3, 1991, real property R remains unimproved and has a fair market value of $250,000. On that date, at B's direction, C purchases 1\1/2\ acres of real property R for $187,500 and transfers it to B, and B pays $87,500 to C.

(ii) The portion of real property R that B received does not differ from the basic nature or character of real property R as a whole. Moreover, the fair market value of the portion of real property R that B received ($187,500) is 75 percent of the fair market value of real property R as of the date of receipt. Accordingly, B is considered to have received substantially the same property as identified.

(e) Special rules for identification and receipt of replacement property to be produced—

(1) In general. A transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of this paragraph (e), the terms ``produced'' and ``production'' have the same meanings as provided in section 263A(g)(1) and the regulations thereunder.

(2) Identification of replacement property to be produced.

(i) In the case of replacement property that is to be produced, the replacement property must be identified as provided in paragraph (c) of this section (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of paragraph (c)(3) of this section (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

(ii) For purposes of paragraphs (c)(4)(i)(B) and (c)(5) of this section (relating to the 200-percent rule and incidental property), the fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.

(3) Receipt of replacement property to be produced.

(i) For purposes of paragraph (d)(1)(ii) of this section (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.

(ii) If the identified replacement property is personal property to be produced, the replacement property received will not be considered to be substantially the same property as identified unless production of the replacement property received is completed on or before the date the property is received by the taxpayer.

(iii) If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

(4) Additional rules. The transfer of relinquished property is not within the provisions of section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind.

(5) Example. This paragraph (e) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers improved real property X and personal property Y to C on May 17, 1991. On or before November 13, 1991 (the end of the exchange period), C is required to transfer to B real property M, on which C is constructing improvements, and personal property N, which C is producing. C is obligated to complete the improvements and production regardless of when properties M and N are transferred to B. Properties M and N are identified in a manner that satisfies paragraphs (c) (relating to identification of replacement property) and (e)(2) of this section. In addition, properties M and N are of a like kind, respectively, to real property X and personal property Y (determined without regard to section 1031(a)(3) and this section). On November 13, 1991, when construction of the improvements to property M is 20 percent completed and the production of property N is 90 percent completed, C transfers to B property M and property N. If construction of the improvements had been completed, property M would have been considered to be substantially the same property as identified. Under local law, property M constitutes real property to the extent of the underlying land and the 20 percent of the construction that is completed.

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

(iii) Property M is considered to be substantially the same property as identified to the extent of the underlying land and the 20 percent of the construction that is completed when property M is received by B. However, any additional construction performed by C with respect to property M after November 13, 1991, is not treated as the receipt of property of a like kind.

(f) Receipt of money or other property—

(1) In general. A transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See Sec. 1.1031(a)-1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

(2) Actual and constructive receipt. Except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

(3) Example. This paragraph (f) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to the agreement, on May 17, 1991, B transfers real property X to C. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. At any time after May 17, 1991, and before C has purchased the replacement property, B has the right, upon notice, to demand that C pay $100,000 in lieu of acquiring and transferring the replacement property. Pursuant to the agreement, B identifies replacement property, and C purchases the replacement property and transfers it to B.

(ii) Under the agreement, B has the unrestricted right to demand the payment of $100,000 as of May 17, 1991. B is therefore in constructive receipt of $100,000 on that date. Because B is in constructive receipt of money in the full amount of the consideration for the relinquished property before B actually receives the like-kind replacement property, the transaction constitutes a sale, and the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031. B is treated as if B received the $100,000 in consideration for the sale of real property X and then purchased the like-kind replacement property.

(iii) If B's right to demand payment of the $100,000 were subject to a substantial limitation or restriction (e.g., the agreement provided that B had no right to demand payment before November 14, 1991 (the end of the exchange period)), then, for purposes of this section, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived.

(g) Safe harbors—

(1) In general. Paragraphs (g)(2) through (g)(5) of this section set forth four safe harbors the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of section 1031 and this section. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For purposes of the safe harbor rules, the term ``taxpayer'' does not include a person or entity utilized in a safe harbor (e.g., a qualified intermediary). See paragraph (g)(8), Example 3(v), of this section.

(2) Security or guarantee arrangements.

(i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following—

(A) A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent),

(B) A standby letter of credit which satisfies all of the requirements of Sec. 15A.453-1 (b)(3)(iii) and which may not be drawn upon in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or

(C) A guarantee of a third party.

(ii) Paragraph (g)(2)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

(3) Qualified escrow accounts and qualified trusts.

(i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.

(ii) A qualified escrow account is an escrow account wherein—

(A) The escrow holder is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) The escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account as provided in paragraph (g)(6) of this section.

(iii) A qualified trust is a trust wherein—

(A) The trustee is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section, except that for this purpose the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under section 267(b)), and

(B) The trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee as provided in paragraph (g)(6) of this section.

(iv) Paragraph (g)(3)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust are disregarded for this purpose.

(v) A taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of paragraph (g)(3)(i) of this section.

(4) Qualified intermediaries.

(i) In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

(ii) Paragraph (g)(4)(i) of this section applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.

(iii) A qualified intermediary is a person who—

(A) Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) Enters into a written agreement with the taxpayer (the ``exchange agreement'') and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

(iv) Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section—

(A) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property,

(B) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and

(C) An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

(v) Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevent transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

(vi) Paragraph (g)(4)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Rights conferred upon the taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded for this purpose.
(vii) A taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of paragraph (g)(4)(i) of this section.

(5) Interest and growth factors. In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. The preceding sentence applies only if the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer's rights to receive the interest or growth factor as provided in paragragh (g)(6) of this section. For additional rules concerning interest or growth factors, see paragraph (h) of this section.

(6) Additional restrictions on safe harbors under paragraphs (g)(3) through (g)(5).

(i) An agreement limits a taxpayer's rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraph (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

(ii) The agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or othewise obtain the benefits of money or other property at any time after the end of the identification period.

(iii) The agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after—

(A) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or

(B) The occurrence after the end of the identification period of a material and substantial contingency that—

(1) Relates to the deferred exchange,

(2) Is provided for in writing, and

(3) Is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer.

(7) Items disregarded in applying safe harbors under paragraphs (g)(3) through (g)(5). In determining whether a safe harbor under paragraphs (g)(3) through (g)(5) of this section ceases to apply and whether the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in paragraph (g)(6) of this section, the taxpayer's receipt of or right to receive any of the following items will be disregarded—

(i) Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents), and

(ii) Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

(8) Examples. This paragraph (g) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X

to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified as provided in paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C. On the same day, C pays $10,000 to B and deposits $90,000 in escrow as security for C's obligation to perform under the agreement. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) if B fails to identify replacement property on or before July 1, 1991, B may demand the funds in escrow at any time after July 1, 1991; And

(B) if B identifies and receives replacement property, then B may demand the balance of the remaining funds in escrow at any time after B has received the replacement property.

The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as defined in paragraph (k) of this section. Pursuant to the terms of the agreement, B identifies replacement property, and C purchases the replacement property using the funds in escrow and tranfers the replacement property to B.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. In addition, B did not have the immediate ability or unrestricted right to receive money or other property in escrow before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $90,000 held in escrow before B received the like-kind replacement property. The transfer of real property X by B and B's acquisition of the replacement property qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 2. (i) On May 17, 1991, B transfers real property X to C, and C deposits $100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) B may demand the funds in escrow at any time after the later of July 1, 1991, and the occurrence of any of the following events—

(1) real property J is destroyed, seized, requisitioned, or condemned, or

(2) a determination is made that the regulatory approval necessary for the transfer of real property J cannot be obtained in time for real property J to be transferred to B before the end of the exchange period;

(B) B may demand the funds in escrow at any time after August 14, 1991, if real property J has not been rezoned from residential to commercial use by that date; and

(C) B may demand the funds in escrow at the time B receives real property J or any time thereafter.

Otherwise, B is entitled to all funds in escrow after November 13, 1991. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as described in paragraph (k) of this section. Real property J is not rezoned from residential to commercial use on or before August 14, 1991.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. From May 17, 1991, until August 15, 1991, B did not have the immediate ability or unrestricted right to receive money or other property before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the $100,000 in escrow from May 17, 1991, until August 15, 1991. However, on August 15, 1991, B had the unrestricted right, upon notice, to draw upon the $100,000 held in escrow. Thus, the safe harbor ceased to apply and B was in constructive receipt of the funds held in escrow. Because B constructively received the full amount of the consideration ($100,000) before B actually received the like-kind replacement property, the transaction is treated as a sale and not as a deferred exchange. The result does not change even if B chose not to demand the funds in escrow and continued to attempt to have real property J rezoned and to receive the property on or before November 13, 1991.

(iii) If real property J had been rezoned on or before August 14, 1991, and C had purchased real property J and transferred it to B on or before November 13, 1991, the transaction would have qualified for nonrecognition of gain or loss under section 1031(a).

Example 3. (i) On May 1, 1991, D offers to purchase real property X for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The exchange agreement between B and C provides that B is to execute and deliver a deed conveying real property X to C who, in turn, is to execute and deliver a deed conveying real property X to D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 3, 1991, C enters into an agreement with D to transfer real property X to D for $100,000. On May 17, 1991, B executes and delivers to C a deed conveying real property X to C. On the same date, C executes and delivers to D a deed conveying real property X to D, and D deposits $100,000 in escrow. The escrow holder is not a disqualified person as defined in paragraph (k) of this section and the escrow agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section. However, the escrow agreement provides that the money in escrow may be used to purchase replacement property. On June 3, 1991, B identifies real property K as replacement property. On August 9, 1991, E executes and delivers to C a deed conveying real property K to C and $80,000 is released from the escrow and paid to E. On the same date, C executes and delivers to B a deed conveying real property K to B, and the escrow holder pays B $20,000, the balance of the $100,000 sale price of real property X remaining after the purchase of real property K for $80,000.

(ii) B and C entered into an exchange agreement that satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Regardless of whether C may have acquired and transferred real property X under general tax principles, C is treated as having acquired and transferred real property X because C acquired and transferred legal title to real property X. Similarly, C is treated as having acquired and transferred real property K because C acquired and transferred legal title to real property K. Thus, C was a qualified intermediary. This result is reached for purposes of this section regardless of whether C was B's agent under state law.

(iii) Because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, the escrow account was a qualified escrow account. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the funds in escrow before B received real property K.

(iv) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of any money held by C as provided in paragraph (g)(6) of this section. Because C was a qualified intermediary, for purposes of section 1031 and this section B is determined not to be in actual or constructive receipt of any funds held by C before B received real property K. In addition, B's transfer of real property X and acquisition of real property K qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(v) If the escrow agreement had expressly limited C's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, but had not expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of that money or other property, the escrow account would not have been a qualified escrow account. Consequently, paragraph (g)(3)(i) of this section would not have been applicable in determining whether B was in actual or constructive receipt of that money or other property before B received real property K.

Example 4. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000 on May 17, 1991. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. In the exchange agreement between B and C, B assigns to C all of B's rights in the agreement with D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 17, 1991, B notifies D in writing of the assignment. On the same date, B executes and delivers to D a deed conveying real property X to D. D pays $10,000 to B and $90,000 to C. On June 1, 1991, B identifies real property L as replacement property. On July 5, 1991, B enters into an agreement to purchase real property L from E for $90,000, assigns its rights in that agreement to C, and notifies E in writing of the assignment. On August 9, 1991, C pays $90,000 to E, and E executes and delivers to B a deed conveying real property L to B.

(ii) The exchange agreement entered into by B and C satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Because B's rights in its agreements with D and E were assigned to C, and D and E were notified in writing of the assignment on or before the transfer of real properties X and L, respectively, C is treated as entering into those agreements. Because C is treated as entering into an agreement with D for the transfer of real property X and, pursuant to that agreement, real property X was transferred to D, C is treated as acquiring and transferring real property X. Similarly, because C is treated as entering into an agreement with E for the transfer of real property K and, pursuant to that agreement, real property K was transferred to B, C is treated as acquiring and transferring real property K. This result is reached for purposes of this section regardless of whether C was B's agent under state law and regardless of whether C is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Thus, C was a qualified intermediary.

(iii) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C as provided in paragraph (g)(6) of this section. Thus, B did not have the immediate ability or unrestricted right to receive money or other property held by C before B received real property L. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the $90,000 held by C before B received real property L. In addition, the transfer of real property X by B and B's acquisition of real property L qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 5. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for $100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The agreement between B and C expressly limits B's rights to receive, pledge, borrow,

or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. C neither enters into an agreement with D to transfer real property X to D nor is assigned B's rights in B's agreement to sell real property X to D. On May 17, 1991, B transfers real property X to D and instructs D to transfer the $100,000 to C. On June 1, 1991, B identifies real property M as replacement property. On August 9, 1991, C purchases real property L from E for $100,000, and E executes and delivers to C a deed conveying real property M to C. On the same date, C executes and delivers to B a deed conveying real property M to B.

(ii) Because B transferred real property X directly to D under B's agreement with D, C did not acquire real property X from B and transfer real property X to D. Moreover, because C did not acquire legal title to real property X, did not enter into an agreement with D to transfer real property X to D, and was not assigned B's rights in B's agreement to sell real property X to D, C is not treated as acquiring and transferring real property X. Thus, C was not a qualified intermediary and paragraph (g)(4))(i) of this section does not apply.

(iii) B did not exchange real property X for real property M. Rather, B sold real property X to D and purchased, through C, real property M. Therefore, the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031.

(h) Interest and growth factors—

(1) In general. For purposes of this section, the taxpayer is treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property.

(2) Treatment as interest. If, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property (including property of a like kind). The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting.

(i) [Reserved]

(j) Determination of gain or loss recognized and the basis of property received in a deferred exchange—

(1) In general. Except as otherwise provided, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the rules of section 1031 and the regulations thereunder. See Sec. Sec. 1.1031(b)-1, 1.1031(c)-1, 1.1031(d)-1, 1.1031(d)-1T, 1.1031(d)-2, and 1.1031(j)-1.

(2) Coordination with section 453—

(i) Qualified escrow accounts and qualified trusts. Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust. This paragraph (j)(2)(i) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(3)(iv) of this section; or

(B) The end of the exchange period.

(ii) Qualified intermediaries. Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(4)(vi) of this section; or

(B) The end of the exchange period.

(iii) Transferee indebtedness. In the case of a transaction described in paragraph (j)(2)(ii) of this section, the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter.

(iv) Bona fide intent requirement. The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period.

(v) Disqualified property. The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply if the relinquished property is disqualified property. For purposes of this paragraph (j)(2), disqualified property means property that is not held for productive use in a trade or business or for investment or is property described in section 1031(a)(2).

(vi) Examples. This paragraph (j)(2) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B is a calendar year taxpayer who agrees to enter into a deferred exchange. Pursuant to the agreement, B is to transfer real property X. Real property X, which has been held by B for investment, is unencumbered and has a fair market value of $100,000 at the time of transfer. B's adjusted basis in real property X at that time is $60,000. B identifies a single like-kind replacement property before the end of the identification period, and B receives the replacement property before the end of the exchange period. The transaction qualifies as a like-kind exchange under section 1031.

Example 1. (i) On September 22, 1994, B transfers real property X to C and C agrees to acquire like-kind property and deliver it to B. On that date B has a bona fide intent to enter into a deferred exchange. C's obligation, which is not payable on demand or readily tradable, is secured by $100,000 in cash. The $100,000 is deposited by C in an escrow account that is a qualified escrow account under paragraph (g)(3) of this section. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash deposited in the escrow account until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers the replacement property to B. The $20,000 in cash remaining in the qualified escrow account is distributed to B at that time.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 in cash that B receives in the exchange. Under paragraph (j)(2)(i) of this section, the qualified escrow account is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of C's obligation on September 22, 1994, does not constitute a payment. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from the qualified escrow account. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method. See section 453(f)(6) for special rules for determining total contract price and gross profit in the case of an exchange described in section 1031(b).

Example 2. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. C is a qualified intermediary under paragraph (g)(4) of this section. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the remaining $20,000 from the transfer of real property X to B.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 cash B receives in the exchange. Under paragraph (j)(2)(ii) of this section, any agency relationship between B and C is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method.

Example 3. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $100,000 from the sale of real property X to B.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis in real property X ($60,000), or $40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the $100,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 4. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is a qualified intermediary under paragraph (g)(4) of this section. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who then transfers it to D for $80,000 in cash and D's 10-year installment obligation for $20,000. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. D's obligation bears adequate stated interest and is not payable on demand or readily tradable. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to B.

(ii) Under section 1031(b), $20,000 of B's gain (i.e., the amount of the installment obligation B receives in the exchange) does not qualify for nonrecognition under section 1031(a). Under paragraphs (j)(2) (ii) and (iii) of this section, B's receipt of D's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of the obligation is not treated as a payment. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain under the installment method on receiving payments from D on the obligation.

Example 5. (i) B is a corporation that has held real property X to expand its manufacturing operations. However, at a meeting in November 1994, B's directors decide that real property X is not suitable for the planned expansion, and authorize a like-kind exchange of this property for property that would be suitable for the planned expansion. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On November 28, 1994, pursuant to the agreement, B transfers real property X to C, who then transfers it to D for $100,000 in cash. The exchange agreement does not include any limitations or conditions that make it unreasonable to believe that like-kind replacement property will be acquired before the end of the exchange period. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period, if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. In early January 1995, B's directors meet and decide that it is not feasible to proceed with the planned expansion due to a business downturn reflected in B's preliminary financial reports for the last quarter of 1994. Thus, B's directors instruct C to stop seeking replacement property. C delivers the $100,000 cash to B on January 12, 1995, at the end of the identification period. Both the decision to exchange real property X for other property and the decision to cease seeking replacement property because of B's business downturn are recorded in the minutes of the directors' meetings. There are no other facts or circumstances that would indicate whether, on November 28, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The directors' authorization of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment until January 12, 1995, on receipt of the $100,000 cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 6. (i) B has held real property X for use in its trade or business, but decides to transfer that property because it is no longer suitable for B's planned expansion of its commercial enterprise. B and D agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to D on September 22, 1994, and D deposits $100,000 cash in a qualified escrow account as security for D's obligation under the agreement to transfer replacement property to B before the end of the exchange period. D's obligation is not payable on demand or readily tradable. The agreement provides that B is not required to accept any property that is not zoned for commercial use. Before the end of the identification period, B identifies real properties J, K, and L, all zoned for residential use, as replacement properties. Any one of these properties, rezoned for commercial use, would be suitable for B's planned expansion. In recent years, the zoning board with jurisdiction over properties J, K, and L has rezoned similar properties for commercial use. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in the escrow account until the earlier of the time that the zoning board determines, after the end of the identification period, that it will not rezone the properties for commercial use or the end of the exchange period. On January 5, 1995, the zoning board decides that none of the properties will be rezoned for commercial use. Pursuant to the exchange agreement, B receives the $100,000 cash from the escrow on January 5, 1995. There are no other facts or circumstances that would indicate whether, on September 22, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make it unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and Sec. 15a.453-1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the $100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

(vii) Effective date. This paragraph (j)(2) is effective for transfers of property occurring on or after April 20, 1994. Taxpayers may apply this paragraph (j)(2) to transfers of property occurring before April 20, 1994, but on or after June 10, 1991, if those transfers otherwise meet the requirements of Sec. 1.1031(k)-1. In addition, taxpayers may apply this paragraph (j)(2) to transfers of property occurring before June 10, 1991, but on or after May 16, 1990, if those transfers otherwise meet the requirements of Sec. 1.1031(k)-1 or follow the guidance of IA-237-84 published in 1990-1, C.B. See Sec. 601.601(d)(2)(ii)(b) of this chapter.

(3) Examples. This paragraph (j) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of $100,000. B's adjusted basis in real property X is $40,000. On or before July 1, 1991 (the end of the identification period), B is to identify

replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received. The replacement property is identified as provided in paragraph (c) of this section and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C and identifies real property R as replacement property. On June 3, 1991, C transfers $10,000 to B. On September 4, 1991, C purchases real property R for $90,000 and transfers real property R to B.

(ii) The $10,000 received by B is ``money or other property'' for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $10,000. Under section 1031(d), B's basis in real property R is $40,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), and increased in the amount of gain recognized ($10,000) in the deferred exchange).

Example 2. (i) On May 17, 1991, B transfers real property X to C and identifies real property S as replacement property, and C transfers $10,000 to B. On September 4, 1991, C purchases real property S for $100,000 and transfers real property S to B. On the same day, B transfers $10,000 to C.

(ii) The $10,000 received by B is ``money or other property'' for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of $10,000. Under section 1031(d), B's basis in real property S is $50,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money received ($10,000), increased in the amount of gain recognized ($10,000), and increased in the amount of the additional consideration paid by B ($10,000) in the deferred exchange).

Example 3. (i) Under the exchange agreement, B has the right at all times to demand $100,000 in cash in lieu of replacement property. On May 17, 1991, B transfers real property X to C and identifies real property T as replacement property. On September 4, 1991, C purchases real property T for $100,000 and transfers real property T to B.

(ii) Because B has the right on May 17, 1991, to demand $100,000 in cash in lieu of replacement property, B is in constructive receipt of the $100,000 on that date. Thus, the transaction is a sale and not an exchange, and the $60,000 gain realized by B in the transaction (i.e., $100,000 amount realized less $40,000 adjusted basis) is recognized. Under section 1031(d), B's basis in real property T is $100,000.

Example 4. (i) Under the exchange agreement, B has the right at all times to demand up to $30,000 in cash and the balance in replacement propertry instead of receiving replacement property in the amount of $100,000. On May 17, 1991, B transfers real property X to C and identifies real property U as replacement property. On September 4, 1991, C purchases real property U for $100,000 and transfers real property U to B.

(ii) The transaction qualifies as a deferred exchange under section 1031 and this section. However, because B had the right on May 17, 1991, to demand up to $30,000 in cash, B is in constructive receipt of $30,000 on that date. Under section 1031(b), B recognizes gain in the amount of $30,000. Under section 1031(d), B's basis in real property U is $70,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money that B received ($30,000), increased in the amount of gain recognized ($30,000), and increased in the amount of additional consideration paid by B ($30,000) in the deferred exchange).

Example 5. (i) Assume real property X is encumbered by a mortgage of $30,000. On May 17, 1991, B transfers real property X to C and identifies real property V as replacement property, and C assumes the $30,000 mortgage on real property X. Real property V is encumbered by a $20,000 mortgage. On July 5, 1991, C purchases real property V for $90,000 by paying $70,000 and assuming the mortgage and transfers real property V to B with B assuming the mortgage.

(ii) The consideration received by B in the form of the liability assumed by C ($30,000) is offset by the consideration given by B in the form of the liability assumed by B ($20,000). The excess of the liability assumed by C over the liability assumed by B, $10,000, is treated as ``money or other property.'' See Sec. 1.1031(b)-1(c). Thus, B recognizes gain under section 1031(b) in the amount of $10,000. Under section 1031(d), B's basis in real property V is $40,000 (i.e., B's basis in real property X ($40,000), decreased in the amount of money that B is treated as receiving in the form of the liability assumed by C ($30,000), increased in the amount of money that B is treated as paying in the form of the liability assumed by B ($20,000), and increased in the amount of the gain recognized ($10,000) in the deferred exchange).

(k) Definition of disqualified person.

(1) For purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

(2) The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account—

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

(3) The person and the taxpayer bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section ``10 percent'' for ``50 percent'' each place it appears).

(4)(i) Except as provided in paragraph (k)(4)(ii) of this section, the person and a person described in paragraph (k)(2) of this section bear a relationship described in either section 267(b) or 707(b) (determined by substituting in each section ``10 percent'' for ``50 percent'' each place it appears).

(ii) In the case of a transfer of relinquished property made by a taxpayer on or after January 17, 2001, paragraph (k)(4)(i) of this section does not apply to a bank (as defined in section 581) or a bank affiliate if, but for this paragraph (k)(4)(ii), the bank or bank affiliate would be a disqualified person under paragraph (k)(4)(i) of this section solely because it is a member of the same controlled group (as determined under section 267(f)(1), substituting ``10 percent'' for ``50 percent' where it appears) as a person that has provided investment banking or brokerage services to the taxpayer within the 2-year period described in paragraph (k)(2) of this section. For purposes of this paragraph (k)(4)(ii), a bank affiliate is a corporation whose principal activity is rendering services to facilitate exchanges of property intended to qualify for nonrecognition of gain under section 1031 and all of whose stock is owned by either a bank or a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)).

(5) This paragraph (k) may be illustrated by the following examples. Unless otherwise provided, the following facts are assumed: On May 1, 1991, B enters into an exchange agreement (as defined in paragraph (g)(4)(iii)(B) of this section) with C whereby B retains C to facilitate an exchange with respect to real property X. On May 17, 1991, pursuant to the agreement, B executes and delivers to C a deed conveying real property X to C. C has no relationship to B described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Example 1. (i) C is B's accountant and has rendered accounting services to B within the 2-year period ending on May 17, 1991, other than with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) C is a disqualified person because C has acted as B's accountant within the 2-year period ending on May 17, 1991.

(iii) If C had not acted as B's accountant within the 2-year period ending on May 17, 1991, or if C had acted as B's accountant within that period only with respect to exchanges intended to qualify for nonrecognition of gain or loss under section 1031, C would not have been a disqualified person.

Example 2. (i) C, which is engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges, is a wholly owned subsidiary of an escrow company that has performed routine escrow services for B in the past. C has previously been retained by B to act as an intermediary in prior section 1031 exchanges.

(ii) C is not a disqualified person notwithstanding the intermediary services previously provided by C to B (see paragraph (k)(2)(i) of this section) and notwithstanding the combination of C's relationship to the escrow company and the escrow services previously provided by the escrow company to B (see paragraph (k)(2)(ii) of this section).

Example 3. (i) C is a corporation that is only engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges. Each of 10 law firms owns 10 percent of the outstanding stock of C. One of the 10 law firms that owns 10 percent of C is M. J is the managing partner of M and is the president of C. J, in his capacity as a partner in M, has also rendered legal advice to B within the 2-year period ending on May 17, 1991, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) J and M are disqualified persons. C, however, is not a disqualified person because neither J nor M own, directly or indirectly, more than 10 percent of the stock of C. Similarly, J's participation in the management of C does not make C a disqualified person.

(l) [Reserved]

(m) Definition of fair market value. For purposes of this section, the fair market value of property means the fair market value of the property without regard to any liabilities secured by the property.

(n) No inference with respect to actual or constructive receipt rules outside of section 1031. The rules provided in this section relating to actual or constructive receipt are intended to be rules for determining whether there is actual or constructive receipt in the case of a deferred exchange. No inference is intended regarding the application of these rules for purposes of determining whether actual or constructive receipt exists for any other purpose.

(o) Effective date. This section applies to transfers of property made by a taxpayer on or after June 10, 1991. However, a transfer of property made by a taxpayer on or after May 16, 1990, but before June 10, 1991, will be treated as complying with section 1031 (a)(3) and this section if the deferred exchange satisfies either the provision of this section or the provisions of the notice of proposed rulemaking published in the Federal Register on May 16, 1990 (55 FR 20278).

[T.D. 8346, 56 FR 19938, May 1, 1991, as amended by T.D. 8535, 59 FR 18749, Apr. 20, 1994; T.D. 8982, 67 FR 4909, Feb. 1, 2002]

CLOSING COSTS

WHAT COSTS CAN BE CONSIDERED ACCEPTABLE "EXCHANGE EXPENSES?" (ARTICLE)

A frequently asked question is "What expenses can be deducted from the exchange proceeds without resulting in a tax consequence?" Although the IRS has not published a complete list of qualifying expenses, there are some rulings that provide general parameters. Brokerage commissions can be deducted from the exchange proceeds (Revenue Ruling 72-456). Other transactional costs may also be able to be deducted if they are paid in connection with the exchange. (Letter Ruling 8328011).

WHAT ARE "EXCHANGE EXPENSES?"

Transactional costs that are referred to as "exchange expenses" on Form 8824 are not specifically listed but should generally include costs that are:

A. A direct cost of selling real property, which typically include:

- Real estate commissions
- Title insurance premiums
- Closing or escrow fees
- Legal fees
- Transfer taxes and Notary Fees
- Recording fees

– or –

B. Costs specifically related to the fact the transaction is an exchange such as the Qualified Intermediary fees.

ITEMS THAT ARE NOT "EXCHANGE EXPENSES"

Although not a complete list, the costs related to obtaining the loan should not be deducted from the proceeds. These and other "non-exchange expenses" include:

- Mortage points and assumption fees
- Credit reports
- Lender's title insurance
- Prorated mortgage insurance
- Loan fees and loan application fees
- Property taxes
- Utility charges
- Association fees
- Hazard insurance
- Credits for lease deposits
- Prepaid rents and security deposits

WHAT TO DO ABOUT EXCHANGE EXPENSES IN A §1031 EXCHANGE? (ARTICLE)

In order to obtain complete deferral of capital gain taxes in an exchange otherwise meeting the requirements of Internal Revenue Code §1031, a taxpayer is generally required to reinvest *all* net sale proceeds generated by the sale of relinquished property in like-kind replacement property within the applicable exchange period (a maximum 180 calendar days). In addition, the taxpayer must not have a direct or indirect right to receive or otherwise obtain the benefit of the exchange proceeds during the exchange period except to acquire like-kind replacement property. Any non like-kind property received by the taxpayer in the exchange, usually referred to as boot, will cause the taxpayer to recognize gain. Under the foregoing rules, the use of exchange funds to pay expenses not related to the exchange could invalidate the exchange to the extent such use results in the taxpayer's constructive receipt of exchange proceeds. In other cases, payment of an expense related to the disposition of relinquished property or acquisition of replacement property may give rise to taxable boot in the exchange but would not create a constructive receipt problem. Finally, payment of certain costs related to the transfer of the relinquished property that may be characterized as selling expenses or exchange expenses are excluded from the seller's amount realized and ignored altogether.

Treasury Regulation §1.1031(k)-1(g)(7) permits certain transactional expenses related to the exchange transaction to be paid from exchange proceeds without disqualifying the exchange. These include items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees). See also Letter Ruling 8328011. Similarly, proposed regulation §1.468B-6(b) states that transactional expenses are "***the usual and customary expenses paid or incurred in connection with a deferred exchange. For example, the costs of land surveys, appraisals, title examinations, termite inspections, transfer taxes, and recording fees are transactional expenses.***" While the payment of transactional expenses out of proceeds will not disqualify an exchange, payment of such items out of exchange proceeds may generate boot resulting in the recognition of some taxable gain. Thus, a careful review of the closing statements on the relinquished property sale and the replacement property purchase before closing is strongly recommended. Often an item that would generate boot can be dealt with in a way that will avoid characterization as boot.

IRS Form 8824, the tax form filed with IRS to report a §1031 exchange transaction, provides that exchange expenses are to be deducted from the contract price in the determination of realized gain. In this context, the term exchange expense is not defined but appears to mean an expense of sale that would be excluded from amount realized in a taxable sale transaction. Examples of these expenses include qualified intermediary fees, escrow closing costs and broker commissions. See e.g. Letter Ruling 8328011, Mercantile Trust Co. of Baltimore v. Comm, 32 BTA 82 (1935), Rev. Rul. 72-456, 1972-2 CB 468. Other selling expenses that might be excluded include transfer taxes, attorney's fees, recording fees and the cost of the owner's title insurance policy. Note however, that an excludable selling expense does not encompass all closing costs or transactional expenses that may be paid with exchange proceeds within the safe harbor provisions of the regulations. For instance, real estate taxes, rent and other prorations and adjustments are not excluded from amount realized in a taxable sale or added to the basis of the property by the buyer. Rather, they are operating costs incurred due to the ownership of the real property. Likewise, as to possible costs to remove or satisfy mechanic's liens or other assessments.

Transactional items that may be paid from exchange proceeds in an exchange, but are usually not considered selling expenses include loan related fees, such as points, mortgage insurance fees, appraisal fees, lender's title insurance premiums and other fees related to financing the acquisition of the replacement property. Such fees must generally be amortized over the life of the loan, do not increase basis in the property and do not affect the calculation of realized or recognized gain. Rev. Rul. 70-360, 1970-2 CB 103, S&L Building Corporation, 19 BTA 788 (1930). While the payment of such costs from proceeds may result in cash boot in the exchange, such expenses may be deductible as well. Some legal and tax advisors take the position that where financing is an express condition to closing in the purchase contract, the payment of finance related fees out of exchange proceeds should not generate boot.

Security deposits, repair costs and prepaid rent that are allocated among buyer and seller in a purchase and sale contract through a standard prorations clause, can be another source of taxable boot if not handled carefully. The prorations clause works by adjusting the amount of cash that must be paid by the buyer at closing. For example, a typical rent proration clause would credit the buyer with rents already received by the seller that are allocable to the period following the closing thereby reducing the amount of cash the buyer must deposit. Such a clause generates boot as the seller has, in effect, treated the prorated amount allocated to the buyer as part of the buyer's consideration for the property. At closing, this cash is in the seller's hands and does not pass to seller's qualified intermediary to be used in the exchange. This is boot, plain and simple. That result could be avoided by having the seller deposit the prorated rents into escrow before the closing. The same rationale applies to other prorated items credited to buyer at closing in the purchase and sale agreement, such as a buyer credit for repairs. In the latter case, a seller may prefer to reduce the purchase price for the property to reflect the cost of the repair (but such a reduction might interfere with the buyer's financing). The characterization of closing costs, exchange expenses and prorations in a tax deferred exchange is an area that can be complex and is generally not well understood by real estate investors. A pre-closing analysis of these items by a qualified tax professional will often turn up potential boot items that can be avoided with proper planning. The goal for some, of course, is to obtain *complete* tax deferral.

REVENUE RULING 72-456

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: 1972

Section 1031 — Exchange of Property Held for Productive Use or Investment

Examples illustrate the effect of brokerage commissions on realized gain and basis of property received in connection with exchanges of property to which section 1031 of the Code applies.

Advice has been requested concerning the proper treatment to be accorded brokerage commissions paid in connection with exchanges of properties that result in nontaxable or partially nontaxable exchanges under section 1031 of the Internal Revenue Code of 1954 in the situations described below.

Situation 1.

A taxpayer exchanged his property, land held for productive use in trade or business or for investment, with an adjusted basis of $12,000, for property of a like kind, to be held for productive use in trade or business or for investment, with a fair market value of $20,000 and $10,000 in cash. He paid a commission of $2,000 to a real estate broker.

Situation 2.

A taxpayer exchanged his property, land held for productive use in trade or business or for investment, with an adjusted basis of $29,500, for property of a like kind, to be held for productive use in trade or business or for investment, with a fair market value of $20,000 and $10,000 in cash. He paid a commission of $2,000 to a real estate broker.

Situation 3.

A taxpayer exchanged his property, land held for productive use in trade or business or for investment, with an adjusted basis of $10,000, for property of a like kind, to be held for productive use in trade or business or for investment, with a fair market value of $20,000. He paid a commission of $2,000 to a real estate broker.

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

Section 1031(b) of the Code provides, in part, that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1031(c) of the Code provides, in part, that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

Section 1.1031(d)-1(c) of the Income Tax Regulations provides, in part, that if, upon an exchange of properties of the type described in section 1031 of the Code, the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b) of the Code, the basis of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange.

Section 1.1031(d)-2 of the regulations, example (2), indicates that money paid out in connection with an exchange under section 1031 of the Code is offset against money received in computing gain realized and gain recognized and is also added in determining the basis of the acquired property. Accordingly, it is held that the three factual situations presented result in the following:

SITUATIONS

Received	1	2	3
Land-F.M.V.	$20,000.00	$20,000.00	$20,000.00
Cash	10,000.00	10,000.00	-0-
Total	$30,000.00	$30,000.00	$20,000.00
Less			
Brokerage commission	2,000.00	2,000.00	2,000.00
Amount realized	$28,000.00	$28,000.00	
Given up:			
Land-basis	12,000.00	29,500.00	10,000.00
Realized gain(loss)	$16,000.00	$(1,500.00)	$8,000.00
Recognized gain (lesser of realized gain or net cash received)	$8,000.00	$-0-	$-0-
Basis			
Land given up-basis	$12,000.00	$29,000.00	$10,000.00
Less cash received	(10,000.00)	(10,000.00)	-0-
Plus recognized gain	8,000.00	-0-	-0-
Plus brokerage commission	2,000.00	2,000.00	2,000.00
Basis of land received	$12,000.00	$21,500.00	$12,000.00

PRIVATE LETTER RULING 8328011

Mar. 31, 1983

Issues

(1) Whether nonmortgage liabilities may be netted with mortgage liabilities under section 1.1031(b)-1(c) of the Income Tax Regulations.

(2) Whether a tenant's rental deposit or security deposit is a liability for purposes of section 1.1031(b)-1(c) of the regulations.
Facts

On June 22, 1978, T, the taxpayer, exchanged with X, the other party to the exchange, a 50 percent interest in Property A for Properties B and C. All of these parcels are real property.

In determining T's recognized gain, the District Office computed the difference in the net equities of the properties exchanged. T's net equity in Property A was computed to be $145,796 (the fair market value of $385,000 • mortgage liabilities of $239,204). Xnet equity in Properties B and C was $116,129 (the fair market value of $545,000 • mortgage liabilities of $428,871). The differential figure of $29,667 ($145,796 • $116,129) constitutes the consideration that X had to pay to T for Property A. This differential is necessarily composed of cash, non-like-kind property and the assumption of nonmortgage liabilities. Subtracting the sales commission and certain other exchange expenses from the differential, the District Office determined that T should recognize gain equal to $12,418 ($29,667 • $17,249 of exchange expenses).

In determining T's recognized gain in T's revised computations, T's accountant computed the difference in the net equities exchanged, taking into account the nonmortgage liabilities as well as the mortgage liabilities. T's net equity in Property A was reported as $138,877 (the fair market value of $385,000 • liabilities assumed by X of $246,123). X's net equity in Properties B and C was reported as $117,392 (the fair market value of $545,000 • liabilities assumed by T of $427,608). The differential of $21,485 ($138,877 • $117,392) equals the consideration that X had to pay T for Property A. Subtracting the exchange expenses from the differential, T's accountant determined that T should recognize gain equal to $4,236 ($21,485 • $17,249).

Applicable LAW:

Section 1031(b) of the Internal Revenue Code provides that when an exchange consists of like kind property and other property, any gain from the transaction shall be recognized in an amount not to exceed the fair market value of the other property.

Section 1.1031(b)-1(c) of the regulations states that consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as “other property or money” for the purposes of section 1031(b) of the Code. Where, on an exchange described in section 1031(b) each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of “other property or money” for purposes of section 1031(b) consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability).

Example (2)(c) of section 1.1031(d) of the regulations provides, in part, that although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.

Rev. Rul. 72-456, 1972-2 C.B. 468, indicates that the recognized gain is equal to the lesser of the realized gain or net cash (or other property) received. The net cash (or other property) received consists of the cash and non-like-kind property received less the expenses of the exchange such as the brokerage commission.

Rationale

The first issue to be resolved is whether nonmortgage liabilities may be netted under section 1031 of the Code. Section 1.1031(b)-1(c) of the regulations provides, in part, that consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). This part of the regulations specifically recognizes the fact that nonmortgage liabilities enter into the computation of net liabilities. Accordingly, it was improper for the District Office to determine the net equities of the properties exchanged without taking into account the nonmortgage liabilities assumed.

Having determined that nonmortgage liabilities assumed are part of the netting process, we must ascertain which of the items listed by T's accountant are liabilities. T's accountant assumes that all items listed in the escrow statement are liabilities.

The parties involved here have not described the items listed in the escrow statement. Therefore we cannot make a definitive statement as to which of the items are liabilities. Of the items listed with respect to Property A, eight of the items are nonexchange expense items. These constitute the following: interest 5/1/78 to closing, late charge, interest 6/15/78 to 6/30/78, Mr, E, interest 6/15/78 to 6/30/78, trust fund deficit, pro rata rents ($2,430 paid to 7/1/78), and rent deposits. The first five items are labeled interest by T's accountant and the last two items are labeled deposits. With respect to Properties B and C the major item at issue is the impound account balance of $3,802.78, representing prepaid rents.

The five items of interest listed above presumably are liabilities of T. The assumption of these liabilities must be taken into account in the netting of equities. The more troublesome items are those relating to rental deposits. T's accountant argues that security and rent deposits under Local Law are liabilities.

The liabilities referred to in section 1031 of the Code relate to sums certain due at a fixed or determinable date of maturity. Section 1.1031(b)-1(c) of the regulations provides that the assumption of a liability is to be treated as money or other property received. The reason for this characterization is that a person who borrows money and is thereafter released from this debt has effectively been paid money (or other property). Accordingly, the release of the indebtedness triggers a realization event.

Under Rev. Rul. 75-363, 1975-2 C.B. 463, a security deposit is generally treated as a grantor trust subject to section 671 of the Code. The landlord of a security deposit acts as a fiduciary with respect to that account. When a tenant's lease is terminated, the security deposit must be repaid to the tenant to the extent there is no damage to the property. The landlord's liability to return the security deposit upon termination of the lease is the same as any fiduciary's duty to return moneys contributed to a trust. The transfer of a security deposit from one landlord to another is the equivalent of a substitution of fiduciaries. It cannot be said that the original landlord has been relieved of a liability by the transferee landlord with respect to the security deposit. The original landlord owes no liability; he simply holds the sums deposited as an agent for the tenants.

The fact that a tenant has prepaid his rent does not make the landlord any less a fiduciary with respect to that deposit. From an accounting standpoint prepaid rent results in a deferred credit since the amount may have to be paid back if the lease is terminated early.

In Rev. Rul. 73-301, 1973-2 C.B. 215, the Service was confronted with the question of whether the assumption of a deferred credit account on the books of the taxpayer is the assumption of a liability for tax purposes. The Service concluded that deferred credits, representing prepaid income, should not be treated as liabilities for purposes of section 752 of the Code. Accordingly, we conclude that the deferred credits here, representing prepaid rent, are not liabilities for purposes of section 1031 of the Code.

Conclusions

(1) In determining the recognized gain, nonmortgage liabilities should be netted with mortgage liabilities.

(2) Items listed in the escrow account that relate to sums certain, due at a fixed or determinable date of maturity, are liabilities for purposes of section 1031 of the Code.

DISASTER RELIEF GRANTED

DISASTER RELIEF GRANTED UNDER IRS NEWS RELEASES (ARTICLE)

Additional Relief for Hurricanes
The IRS issued Notice 2005-3 on 13 January 2005. This provides relief, in addition to that previously provided under News Releases 2004-108, -115, -118, for persons involved in a section 1031 exchange and impacted by the hurricanes/tropical storms in the southeastern U.S. this past summer and fall. Relief granted under the News Releases was quite limited – frequently frustratingly so – and the relief granted under Notice 2005-3 is much more extensive. Significantly, this Notice provides relief if, among other things, the relinquished or replacement property is located in the disaster area, the principal place of business of any party to the exchange (i.e. exchanger, QI, closer, lender, etc.) is located in the disaster area, or the lender or title insurer backs out because of the of the disaster. Generally, to qualify for the relief, the relinquished property must have been transferred on or before the date of the declared disaster. In addition, it is significant that qualification for the relief is, in some circumstances, less mechanical than under the News Releases.

General Relief
Generally, in a delayed exchange if an exchanger or the exchange meets the Qualification Criteria [see below], the 45-day ID period and/or the 180-day Exchange Period is extended to [1] 120 days later than the original date or [2] December 30 2004, whichever is later.

Qualification Criteria
An exchanger qualifies for an extended 45-day identification period and 180-day exchange period under General Relief [above] only if:

(1) The relinquished property was transferred on or before the date of the Presidentially declared disaster area; AND
(2) Either (a) OR (b) applies
(a) The exchanger is
(i) An individual whose principal residence is located in the disaster area; OR
(ii) A business entity or sole proprietor whose principal place of business is located in the disaster area; OR
(iii) An individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in the disaster area; OR
(iv) An individual whose principal residence, or a business entity or sole proprietor whose records necessary to meet a deadline for an act specified in paragraph (c) of this section are maintained in the disaster area: OR
(v) An estate or trust that has tax records necessary to meet a deadline for an act specified in paragraph (c) of this section and that are maintained in the disaster area; OR
(vi) The spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife; OR
(vii) Any other person determined by the IRS to be affected by a Presidentially declared disaster. OR

(b) The exchanger has difficulty meeting the 45-day identification or 180-day exchange deadline due to the Presidentially declared disaster for any one of the following or similar reasons:
(i) The relinquished property or the replacement property is located in the disaster area as provided in the IRS News Release or other guidance; OR
(ii) The principal place of business of any party to the transaction (for example, a qualified intermediary, transferee, settlement attorney, lender, financial institution, or a title insurance company) is located in the disaster area; OR
(iii) Any party to the transaction (or an employee of such a party who is involved in the § 1031 transaction) is killed, injured, or missing as a result of the disaster; OR
(iv) A document prepared in connection with the exchange (for example, the exchange agreement between the exchanger and the qualified intermediary or the deed to the relinquished property or replacement property) or a relevant land record is destroyed, damaged, or lost as a result of the disaster; OR
(v) A lender decides not to fund either permanently or temporarily a real estate closing due to the disaster or refuses to fund a loan to the taxpayer because flood, disaster, or other hazard insurance is not available due to the disaster; OR
(vi) A title insurance company is not able to provide the required title insurance policy necessary to settle or close a real estate transaction due to the disaster.

Additional Relief for Substantially Damaged Identified Replacement Property
The postponement described in General Relief [above] also applies to the last day of a 45-day identification period that falls prior to the date of a Presidentially declared disaster if an identified replacement property is substantially damaged by the disaster.

REVENUE PROCEDURE 2007-56

SECTION 1. PURPOSE AND NATURE OF CHANGES

.01 This revenue procedure provides an updated list of time-sensitive acts, the performance of which may be postponed under sections 7508 and 7508A of the Internal Revenue Code (Code). Section 7508 postpones specified acts for individuals serving in the Armed Forces of the United States or serving in support of such Armed Forces, in a combat zone, or serving with respect to a contingency operation (as defined in 10 U.S.C. § 101(a)(13)). Section 7508A permits a postponement of the time to perform specified acts for taxpayers affected by a Presidentially declared disaster or a terroristic or military action. The list of acts in this revenue procedure supplements the list of postponed acts in section 7508(a)(1) and section 301.7508A-1(c)(1)(vii) of the Procedure and Administration Regulations. Rev. Proc. 2005-27 is superseded.

.02 This revenue procedure does not, by itself, provide any postponements under section 7508A. In order for taxpayers to be entitled to a postponement of any act listed in this revenue procedure, the IRS generally will publish a notice or issue other guidance (including an IRS News Release) providing relief with respect to a Presidentially declared disaster, or a terroristic or military action. See section 4.01 of this revenue procedure.

.03 For purposes of section 7508, this revenue procedure sets forth such other acts as contemplated by section 7508(a)(1)(K). Unlike section 7508A, when a taxpayer qualifies under section 7508, all the acts listed in section 7508(a)(1) are postponed. Therefore, when a taxpayer qualifies under section 7508, the acts listed in this revenue procedure are also postponed for that taxpayer, whether or not the IRS publishes a notice or issues other guidance.

.04 This revenue procedure will be updated as needed when the IRS determines that additional acts should be included in the list of postponed acts or that certain acts should be removed from the list. Also, taxpayers may recommend that additional acts be considered for postponement under sections 7508 and 7508A. See section 19 of this revenue procedure.

.05 *Significant Changes.* When a Presidentially declared disaster occurs, the IRS guidance usually postpones the time to perform the acts in section 301.7508A-1(c)(1) as well as this revenue procedure. However, because these acts are only listed in the regulations under the disaster relief provision, when an individual qualifies for relief by virtue of service in a combat zone, the time for performing those acts are not postponed. Thus, to ensure that individuals serving in or serving in support of the Armed Forces in a combat zone or contingency operation receive a postponement of time to perform these acts this revenue procedure now includes these acts.

Certain acts, such as filing Tax Court petitions in innocent spouse and other non-deficiency cases, and making certain distributions from, contributions to, recharacterizations of, and certain transactions involving qualified retirement plans (as defined in section 4974(c)), have been added to this revenue procedure even though they are also listed as acts postponed under section 301.7508A-1(c)(1).

SECTION 2. BACKGROUND

.01 Section 7508(a)(1) of the Code permits a postponement of certain time-sensitive acts for individuals serving in the Armed Forces of the United States or serving in support of such Armed Forces in an area designated by the President as a combat zone under section 112(c)(2) or serving with respect to a contingency operation (as defined in 10 U.S.C. § 101(a)(13)). Among these acts are the filing of certain returns, the payment of certain taxes, the filing of a Tax Court petition for redetermination of a deficiency, and the filing of a refund claim. In the event of service in a combat zone or service with respect to a contingency operation, the acts specified in section 7508(a)(1) are automatically postponed. This revenue procedure sets forth such other acts as contemplated by section 7508(a)(1)(K). Thus, the acts listed in this revenue procedure are also automatically postponed. In addition, the Service may include acts not listed in this revenue procedure in any other published guidance (including an IRS News Release) related to the combat zone or contingency operation.

.02 Section 7508A provides that certain acts performed by taxpayers and the government may be postponed if the taxpayer is affected by a Presidentially declared disaster or a terroristic or military action. A "Presidentially declared disaster" is defined in section 1033(h)(3). A "terroristic or military action" is defined in section 692(c)(2). Section 301.7508A-1(d)(1) defines seven types of affected taxpayers, including any individual whose principal residence (for purposes of section 1033(h)(4)) is located in a "covered disaster area" and any business entity or sole proprietor whose principal place of business is located in a "covered disaster area." Postponements under section 7508A are not available simply because a disaster or a terroristic or military action has occurred. Generally, the IRS will publish a notice or issue other guidance (including an IRS News Release) authorizing the postponement. See section 4.01 of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to individuals serving in the Armed Forces of the United States in a combat zone, or serving in support of such Armed Forces, individuals serving with respect to contingency operations, affected taxpayers by reason of Presidentially declared disasters within the meaning of section 301.7508A-1(d)(1), and taxpayers whom the IRS determines are affected by a terroristic or military action. Section 17 of this revenue procedure also applies to transferors who are not affected taxpayers but who are involved in a section 1031 like-kind exchange transaction and are entitled to relief under section 17.02(2) of this revenue procedure.

SECTION 4. APPLICATION

.01 As provided by section 301.7508A-1(e), in the event of a Presidentially declared disaster or terroristic or military action, the IRS will issue a news release or other guidance authorizing the postponement of acts described in this revenue procedure and that will define which taxpayers are considered to be "affected taxpayers" and will describe the acts postponed, the duration of the postponement, and the location of the covered disaster area. See, for example, Notice 2005-73, 2005-2 C.B. 723 (summarizing the relief provided for Hurricane Katrina in news releases IR-2005-84, IR-

2005-91, IR-2005-96, and IR-2005-103). The guidance may provide for postponement of only certain acts listed in this revenue procedure based on the time when the disaster occurred, its severity, and other factors. Unless the notice or other guidance for a particular disaster provides that the relief is limited, the guidance will generally postpone all of the acts listed in the regulations and this revenue procedure.

.02 Provisions of the internal revenue laws requiring the timely performance of specified acts that may be postponed under sections 7508 and 7508A are listed in the tables below. In addition, section 17 of this revenue procedure expands the categories of taxpayers qualifying for relief to include transferors of certain property and provides additional postponements of deadlines solely with respect to section 1031 like-kind exchange transactions that are affected by a Presidentially declared disaster. If an IRS News Release or other guidance is issued with respect to a specific Presidentially declared disaster and authorizes postponement of acts in this revenue procedure, affected taxpayers may use the postponement rules provided in section 17 in lieu of section 6. Transferors who are covered by the like-kind exchange rules of section 17, but who are not "affected taxpayers" as defined by the IRS News Release or other guidance or section 301.7508A-1(d)(1) are not eligible for relief under section 7508A or other sections of this revenue procedure.

.03 The following tables may, but do not necessarily, include acts specified in sections 7508 or 7508A and the regulations thereunder. Thus, for example, no mention is made in the following tables of the filing of tax returns or the payment of taxes (or an installment thereof) because these acts are already covered by sections 7508 and 7508A and the applicable regulations. Also, the following tables generally do not refer to the making of elections required to be made on tax returns or attachments thereto. Reference to these elections is not necessary because postponement of the filing of a tax return automatically postpones the making of any election required to be made on the return or an attachment thereto.

This revenue procedure, however, does include acts that are postponed under section 301.7508A-1(c)(1). The regulation lists acts that may be postponed when there has been a Presidentially declared disaster, but does not apply to postpone acts for individuals serving in, or serving in support of, the Armed Forces of the United States in a combat zone or contingency operation. For example, section 301.7508A-1(c)(1)(iii) provides a postponement for certain contributions to, distributions from qualified retirement plans. This revenue procedure also includes these acts to reflect that they are postponed for individuals serving in, or serving in support of, the Armed Forces of the United States in a combat zone or contingency operation.

.04 The following tables refer only to postponement of acts performed by taxpayers. Additional guidance will be published in the Internal Revenue Bulletin if a decision is made that acts performed by the government may be postponed under section 7508A. See, for example, Notice 2005-82, 2005-2 C.B. 978.

SECTION 5. ACCOUNTING METHODS AND PERIODS

Statute or Regulation	Act Postponed
1. Chapter 1, Subchapter E of the Code	Any act relating to the adoption, election, retention, or change of any accounting method or accounting period, or to the use of an accounting method or accounting period, that is required to be performed on or before the due date of a tax return (including extensions). Examples of such acts include (a) the requirements in Rev. Procs. 2006-45, 2006-45 I.R.B. 851, 2006-46, 2006-45 I.R.B. 859, and 2002-39, 2002-1 C.B. 1046, and 2003-62, 2003-2 C.B. 299, that Form 1128, *Application To Adopt, Change, or Retain a Tax Year*, be filed with the Director, Internal Revenue Service Center, on or before the due date (or the due date including extensions) of the tax return for the short period required to effect the change in accounting period; and (b) the requirement in Rev. Proc. 2002-9, 2002-1 C.B. 327, section 6.02(3) that a copy of *Application for Change in Accounting Method* (Form 3115) must be filed with the national office no later than when the original Form 3115 is filed with the timely filed tax return for the year of the accounting method change.
2. Treas. Reg. § 1.381(c)(4)-1(d)(2)	If the acquiring corporation is not permitted to use the method of accounting previously used by it, or the method of accounting used by the distributor/transferor corporation, or the principal method of accounting; or if the corporation wishes to use a new method of accounting, then the acquiring corporation must apply to the Commissioner to use another method. Section 1.381(c)(4)-1(d)(2) requires applications to be filed not later than 90 days after the date of distribution or transfer. Rev. Proc. 2005-63, 2005-2 C.B. 491, provides that applications are due by the later of (1) the last day of the tax year in which the distribution or transfer occurred, or (2) the earlier of (a) the day that is 180 days after the date of distribution or transfer, or (b) the day on which the taxpayer files its federal income tax return for the taxable year in which the distribution or transfer occurred.
3. Treas. Reg. § 1.381(c)(5)-1(d)(2)	If the acquiring corporation is not permitted to use the inventory method previously used by it, or the inventory method used by the distributor/transferor corporation, or the principal inventory method of accounting, or wishes to use a new inventory method of accounting, then the acquiring corporation must apply to the Commissioner to use another method. Section 1.381(c)(5)-1(d)(2) requires applications to be filed not later than 90 days after the date of distribution or transfer. Rev. Proc. 2005-63 provides that applications are due by the later of (1) the last day of the taxable year in which the distribution or transfer occurred, or (2) the earlier of (a) the day that is 180 days after the date of distribution or transfer, or (b) the day on which the taxpayer files its federal income tax return for the tax year in which the distribution or transfer occurred.
4. Treas. Reg. § 1.442-1(b)(1)	In order to secure prior approval of an adoption, change, or retention of a taxpayer's annual accounting period, the taxpayer generally must file an application on Form 1128, *Application To Adopt, Change, or Retain a Tax Year*, with the Commissioner within such time as is provided in administrative procedures published by the Commissioner from time to time. See, for example, Rev. Procs. 2006-45, 2006-46, 2002-39 and 2003-62.
5. Treas. Reg. § 1.444-3T(b)(1)	A section 444 election must be made by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year*, with the Service Center. Generally, Form 8716 must be filed by the earlier of (a) the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or (b) the due date (without regard to extensions) of the income tax return resulting from the section 444 election.

Statute or Regulation	Act Postponed
6. Treas. Reg. § 1.446-1(e)(2)(i)	Section 6 of Rev. Proc. 2002-9, at 341, allows a taxpayer to change a method of accounting within the terms of the revenue procedure by attaching the application form to the timely filed return for the year of change. Section 6.02(3)(b)(i) grants an automatic extension of 6 months within which to file an amended return with the application for the change following a timely filed original return for the year of change.
7. Treas. Reg. § 1.446-1(e)(3)(i)	To secure the Commissioner's consent to a change in method of accounting, the taxpayer must file an application on Form 3115, *Application for Change in Accounting Method*, with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting (*i.e.*, must be filed by the last day of such taxable year). This filing requirement is also in Rev. Proc. 97-27, 1997-1 C.B. 680. (But see Rev. Proc. 2002-9 for automatic changes in method of accounting that can be made with the return.)
8. Sec. 451(e)	Section 451(e) permits a taxpayer using the cash receipts and disbursements method of accounting who derives income from the sale or exchange of livestock in excess of the number he would sell if he followed his usual business practices to elect (which election is deemed valid if made within the period described in section 1033(e)(2)) to include such income for the taxable year following the taxable year of such sale or exchange if, under his usual business practices, the sale or exchange would not have occurred if it were not for drought, flood, or other weather-related conditions and that such conditions resulted in the area being designated as eligible for Federal assistance.
9. Treas. Reg. § 1.461-1(c)(3)(ii)	A taxpayer may elect, with the consent of the Commissioner, to accrue real property taxes ratably in accordance with section 461(c). A written request for permission to make such an election must be submitted within 90 days after the beginning of the taxable year to which the election is first applicable. Rev. Proc. 2005-63 provides that a request to adopt the method of accounting described in § 1.461-1(c)(3)(ii) may be submitted during the taxable year in which the taxpayer desires to make the change in method of accounting.
10. Treas. Reg. § 1.7519-2T(a)(2), (3) and (4)	A partnership or S corporation must file the Form 8752, *Required Payment or Refund Under Section 7519*, if the taxpayer has made an election under section 444 to use a taxable year other than its required taxable year and the election is still in effect. The Form 8752 must be filed and any required payment must be made by the date stated in the instructions to Form 8752.
11. Rev. Proc. 92-29, Section 6.02	A developer of real estate requesting the Commissioner's consent to use the alternative cost method must file a private letter ruling request within 30 days after the close of the taxable year in which the first benefited property in the project is sold. The request must include a consent extending the period of limitation on the assessment of income tax with respect to the use of the alternative cost method.

SECTION 6. BUSINESS AND INDIVIDUAL TAX ISSUES

Statute or Regulation	Act Postponed
1. Treas. Reg. § 1.71-1T(b), Q&A-7	A payer spouse may send cash to a third party on behalf of a spouse that qualifies for alimony or separate maintenance payments if the payments are made to the third party at the written request or consent of the payee spouse. The request or consent must state that the parties intend the payment to be treated as an alimony payment to the payee spouse subject to the rules of section 71. The payer spouse must receive the request or consent prior to the date of filing of the payer spouse's first return of tax for the taxable year in which the payment was made.
2. Treas. Reg. § 1.77-1	A taxpayer who receives a loan from the Commodity Credit Corporation may elect to include the amount of the loan in his gross income for the taxable year in which the loan is received. The taxpayer in subsequent taxable years must include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Section 1.77-1 requires such requests to be filed within 90 days after the beginning of the taxable year of change. Rev. Proc. 2005-63 provides that a request for consent to adopt the method of accounting described in § 1.77-1 may be submitted during the taxable year in which the taxpayer desires to make the change in method of accounting; however, taxpayers within the scope of Rev. Proc. 2002-9 for the requested year of change that desire to make the changes in method described in § 1.77-1 must follow the procedures in Rev. Proc. 2002-9.
3. Treas. Reg. § 1.110-1(b)(4)(ii)(A)	The lessee must expend its construction allowance on the qualified long-term real property within eight and one-half months after the close of the taxable year in which the construction allowance was received.
4. Sec. 118(c)(2)	A contribution in aid of construction received by a regulated public utility that provides water or sewerage disposal services must be expended by the utility on qualifying property before the end of the second taxable year after the year in which it was received by the utility.
5. Sec. 170(f)(12)(C)	A taxpayer claiming a charitable contribution deduction of more than $500 for a gift of a qualified vehicle must obtain a written acknowledgment of the contribution by the donee organization within 30 days of the contribution or the sale of the vehicle by the donee organization, as applicable.
6. Treas. Reg. § 1.170A-5(a)(2)	A contribution of an undivided present interest in tangible personal property shall be treated as made upon receipt by the donee of a formally executed and acknowledged deed of gift. The period of initial possession by the donee may not be deferred for more than one year.
7. Sec. 172(b)(3)	A taxpayer entitled to a carryback period under section 172(b)(1) may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year. The taxpayer must make the election by the due date of the taxpayer's federal income tax return (including extensions) for the taxable year of the net operating loss for which the election is to be effective.
8. Sec. 172(f)(6)	A taxpayer entitled to a 10-year carryback under section 172(b)(1)(C) (relating to certain specified liability losses) from any loss year may elect to have the carryback period with respect to such loss year determined without regard to that section. The taxpayer

Statute or Regulation	Act Postponed
	must make the election by the due date of the taxpayer's federal income tax return (including extensions) for the taxable year of the net operating loss.
9. Sec. 172(i)(3)	A taxpayer entitled to a 5-year carryback period under section 172(b)(1)(G) (relating to certain farming losses) from any loss year may elect to have the carryback period with respect to such loss year determined without regard to that section. The taxpayer must make the election by the due date of the taxpayer's federal income tax return (including extensions) for the taxable year of the net operating loss.
10. Sec. 468A(g)	A taxpayer that makes payments to a nuclear decommissioning fund with respect to a taxable year must make the payments within $2^1/_2$-months after the close of such taxable year (the deemed payment date).
11. Treas. Reg. § 1.468A-3(h)(1)(v)	A taxpayer must file a request for a schedule of ruling amounts for a nuclear decommissioning fund by the deemed payment date ($2^1/_2$-months after the close of the taxable year for which the schedule of ruling amounts is sought).
12. Treas. Reg. § 1.468A-3(h)(1)(vii)	A taxpayer has 30 days to provide additional requested information with respect to a request for a schedule of ruling amounts. If the information is not provided within the 30 days, the request will not be considered filed until the date the information is provided.
13. Sec. 529(c)(3)(C)(i)	A rollover contribution to another qualified tuition program must be made no later than the 60th day after the date of a distribution from a qualified tuition program.
14. Sec. 530(b)(5)	An individual shall be deemed to have made a contribution to a Coverdell education savings account on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (not including extensions thereof).
15. Sec. 530(d)(4)(C)(i)	Excess contributions (and any earnings on the excess) to a Coverdell education savings account must be distributed before the first day of the sixth month of the following taxable year.
16. Sec. 530(d)(5)	A rollover contribution to another Coverdell education savings account must be made no later than the 60th day after the date of a payment or distribution from a Coverdell education savings account.
17. Sec. 530(h)	A trustee of a Coverdell education savings account must provide certain information concerning the account to the beneficiary by January 31 following the calendar year to which the information relates. In addition, Form 5498-ESA, *Coverdell ESA Contribution Information*, must be filed with the IRS by May 31 following the calendar year to which the information relates.
18. Sec. 563(a)	In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the $3^1/_2$-month period within which the dividend is paid is the period extended.
19. Sec. 563(b)	In the determination of the dividends paid deduction for purposes of the personal holding company tax imposed by section 541, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall, to the extent the taxpayer elects in its return for the taxable year, be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the $3^1/_2$-month period within which the dividend is paid is the period extended.
20. Sec. 563(d)	For the purpose of applying section 562(a), with respect to distributions under subsection (a) or (b) of section 562, a distribution made after the close of the taxable year and on or before the 15th day of the third month following the close of the taxable year shall be considered as made on the last day of such taxable year. The close of the taxable year is not affected by this revenue procedure; the $3^1/_2$-month period within which the dividend is paid is the period extended.
21. Sec. 1031(a)(3)	In a deferred exchange, property otherwise qualified as like-kind property under section 1031 is treated as like-kind property if the 45-day identification period and the 180-day exchange period requirements under section 1031(a)(3) and section 1.1031(k)-1(b)(2) are met. See also section 17 of this revenue procedure.
22. Sec. 1031	Property held in a qualified exchange accommodation arrangement may qualify as "replacement property" or "relinquished property" under section 1031 if the requirements of section 4 of Rev. Proc. 2000-37, 2000-2 C.B. 308, modified by Rev. Proc. 2004-51, 2004-2 C.B. 294, are met, including the 5-business day period to enter into a qualified exchange accommodation agreement (QEAA), the 45-day identification period, the 180-day exchange period, and the 180-day combined time period. See also section 17 of this revenue procedure.
23. Sec. 1033	An election respecting the nonrecognition of gain on the involuntary conversion of property (section 1.1033(a)-2(c)(1) and (2)) is required to be made within the time periods specified in section 1.1033(a)-2(c)(3), section 1.1033(g)-1(c), section 1033(e)(2)(A), or section 1033(h)(1)(B), as applicable.
24. Sec. 1043(a)	If an eligible person (as defined under section 1043(b)) sells any property pursuant to a certificate of divestiture, then at the election of the taxpayer, gain from such sale shall be recognized only to the extent that the amount realized on such sale exceeds the cost of any permitted property purchased by the taxpayer during the 60-day period beginning on the date of such sale.
25. Sec. 1045(a)	A taxpayer other than a corporation may elect to roll over gain from the sale of qualified small business stock held for more than six months if other qualified small business stock is purchased by the taxpayer during the 60-day period beginning on the date of sale.
26. Sec. 1382(d)	An organization, to which section 1382(d) applies, is required to pay a patronage dividend within $8^1/_2$-months after the close of the year.
27. Sec. 1388(j)(3)(A)	Any cooperative organization that exercises its option to net patronage gains and losses, is required to give notice to its patrons of the netting by the 15th day of the 9th month following the close of the taxable year.
28. Treas. Reg.	The effective date of an entity classification election (Form 8832, *Entity Classification Election*) cannot be more than 75 days prior

Statute or Regulation	Act Postponed
§ 301.7701-3(c)	to the date on which the election is filed.
29. Treas. Reg. § 301.9100-2(a)(1)	An automatic extension of 12 months from the due date for making a regulatory election is granted to make certain elections described in section 301.9100-2(a)(2), including the election to use other than the required taxable year under section 444, and the election to use the last-in, first out (LIFO) inventory method under section 472.
30. Treas. Reg. §§ 301.9100-2(b)-(d)	An automatic extension of 6 months from the due date of a return, excluding extensions, is granted to make the regulatory or statutory elections whose due dates are the due date of the return or the due date of the return including extensions (for example, a taxpayer has an automatic 6 month extension to file an application to change a method of accounting under Rev. Proc. 2002-9), provided the taxpayer (a) timely filed its return for the year of election, (b) within that 6-month extension period, takes the required corrective action to file the election in accordance with the statute, regulations, revenue procedure, revenue ruling, notice, or announcement permitting the election, and (c) writes at the top of the return, statement of election or other form "FILED PURSUANT TO § 301.9100-2."

SECTION 7. CORPORATE ISSUES

Statute or Regulation	Act Postponed
1. Sec. 302(e)(1)	A corporation must complete a distribution in pursuance of a plan of partial liquidation of a corporation within the specified period.
2. Sec. 303 and Treas. Reg. § 1.303-2	A corporation must complete the distribution of property to a shareholder in redemption of all or part of the stock of the corporation which (for Federal estate tax purposes) is included in determining the estate of a decedent. Section 303 and section 1.303-2 require, among other things, that the distribution occur within the specified period.
3. Sec. 304(b)(3)(C)	If certain requirements are met, section 304(a) does not apply to a transaction involving the formation of a bank holding company. One requirement is that within a specified period (generally 2 years) after control of a bank is acquired, stock constituting control of the bank is transferred to a bank holding company in connection with the bank holding company's formation.
4. Sec. 316(b)(2)(A) and (B)(ii) and Treas. Reg. § 1.316-1(b)(2)	A personal holding company may designate as a dividend to a shareholder all or part of a distribution in complete liquidation described in section 316(b)(2)(B) and section 1.316-1(b) within 24 months after the adoption of a plan of liquidation by, *inter alia*, following the procedure provided by Treas. Reg. § 1.316-1(b)(5).
5. Sec. 332(b) and Treas. Reg. §§ 1.332-3 and 1.332-4	A corporation must completely liquidate a corporate subsidiary within the specified period.
6. Sec. 338(d)(3) and (h), and Treas. Reg. § 1.338-2	An acquiring corporation must complete a "qualified stock purchase" of a target corporation's stock within the specified acquisition period.
7. Sec. 338(g) and Treas. Reg. § 1.338-2	An acquiring corporation may elect to treat certain stock purchases as asset acquisitions. The election must be made within the specified period.
8. Sec. 338(h)(10) and Treas. Reg. § 1.338(h)(10)-1(c)	An acquiring corporation and selling group of corporations may elect to treat certain stock purchases as asset purchases, and to avoid gain or loss upon the stock sale. The election must be made within the specified period.
9. Treas. Reg. § 1.381(c)(17)-1(c)	An acquiring corporation files a Form 976, *Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust*, within 120 days after the date of the determination under section 547(c) to claim a deduction of a deficiency dividend.
10. Treas. Reg. § 1.441-3(b)	A personal service corporation may obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period by filing Form 1128, *Application To Adopt, Change, or Retain a Tax Year*, within such time as is provided in the administrative procedures published by the Commissioner. See Rev. Procs. 2006-46, 2006-45 I.R.B. 859, and Rev. Proc. 2002-39, 2002-1 C.B. 1046.
11. Sec. 562(b)(1)(B)	In the case of a complete liquidation (except in the case of a complete liquidation of a personal holding company) occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to such plan shall, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend for purposes of computing the dividends paid deduction.
12. Sec. 562(b)(2)	In the case of a complete liquidation of a personal holding company occurring within 24 months after the adoption of a plan of liquidation, the amount of any distribution within such period pursuant to such plan shall be treated as a dividend for purposes of computing the dividends paid deduction to the extent that such is distributed to corporate distributees and represents such corporate distributees' allocable share of the undistributed personal holding company income for the taxable year of such distribution.
13. Sec. 597 and Treas. Reg. § 1.597-	A consolidated group of which an Institution (as defined by section 1.591-1(b)) is a subsidiary may elect irrevocably not to include the Institution in its affiliated group if the Institution is placed in Agency (as defined by section 1.591-1(b)) receivership

Statute or Regulation	Act Postponed
4(g)	(whether or not assets or deposit liabilities of the Institution are transferred to a Bridge Bank (as defined by section 1.591-1(b)). Except as otherwise provided in section 1.597-4(g)(6), a consolidated group makes the election by sending a written statement by certified mail to the affected Institution on or before the later of 120 days after its placement in Agency (as defined by section 1.591-1(b)) receivership or May 31, 1996.
14. Sec. 1502 and Treas. Reg. § 1.1502-75(c)(1)(i)	A common parent must apply for permission to discontinue filing consolidated returns within a specified period after the date of enactment of a law affecting the computation of tax liability.
15. Sec. 6425 and Treas. Reg. § 1.6425-1	Corporations applying for an adjustment of an overpayment of estimated income tax must file Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax*, on or before the 15th day of the third month after the taxable year, or before the date the corporation first files its income tax return for such year, whichever is earlier.
16. Rev. Proc. 2003-33, Section 5	If the filer complies with the procedures set forth in the revenue procedure, including a requirement that the filer file Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases*, within the specified period, the filer gets an automatic extension under section 301.9100-3 to file an election under section 338.

SECTION 8. EMPLOYEE BENEFIT ISSUES

Statute or Regulation	Act Postponed
1. Sec. 72(p)(2)(B) and (C), and Treas. Reg. § 1.72(p)-1, Q&A-10	A loan from a qualified employer plan to a participant in, or a beneficiary of, such plan must be repaid according to certain time schedules specified in section 72(p)(2)(B) and (C) (including, if applicable, any grace period granted pursuant to section 1.72(p)-1, Q&A-10).
2. Sec. 72(t)(2)(A)(iv)	Under section 72(t)(2)(A)(iv), to avoid the imposition of a 10-percent additional tax on a distribution from a qualified retirement plan, the distribution must be part of a series of substantially equal periodic payments, made at least annually.
3. Sec. 72(t)(2)(F)	To avoid the imposition of a 10-percent additional tax on a distribution from an individual retirement arrangement (IRA) for a first-time home purchase, such distribution must be used within 120 days of the distribution to pay qualified acquisition costs or rolled into an IRA.
4. Sec. 72(t)(2)(G)	Under section 72(t)(2)(G), all or part of a distribution from a retirement plan to an individual called to active duty may be repaid into an IRA within 2 years after the active duty period ends (or later, if section 72(t)(2)(G)(iv) applies).
5. Sec. 83(b) and Treas. Reg. § 1.83-2(b)	If substantially nonvested property to which section 83 applies is transferred to any person, the service provider may elect to include the excess of the fair market value of the property over the amount paid (if any) for the property in gross income for the taxable year in which such property is transferred. This election must occur not later than 30 days after the date the property was transferred.
6. Proposed Treas. Reg. § 1.125-1, Q&A-15	Cafeteria plan participants will avoid constructive receipt of the taxable amounts if they elect the benefits they will receive before the beginning of the period during which the benefits will be provided.
7. Proposed Treas. Reg. § 1.125-1, Q&A-14 and Proposed Treas. Reg. § 1.125-2, Q&A-7	Cafeteria plan participants will not be in constructive receipt if, at the end of the plan year, they forfeit amounts elected but not used during the plan year.
8. Proposed Treas. Reg. § 1.125-2, Q&A-5	Cafeteria plan participants may receive in cash the value of unused vacation days on or before the earlier of the last day of the cafeteria plan year or the last day of the employee's taxable year to which the unused days relate.
9. Treas. Reg. § 1.162-27(e)(2)	A performance goal is considered preestablished if it is established in writing by the corporation's compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates if the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. In no event, however, will the performance goal be considered pre-established if it is established after 25 percent of the period of service has elapsed.
10. Sec. 219(f)(3)	A contribution to an individual retirement account shall be deemed to have been made by the taxpayer on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed for filing the return (not including extensions thereof) for such taxable year.
11. Sec. 220(f)(5)	A rollover contribution to an Archer MSA must be made no later than the 60th day after the day on which the holder receives a payment or distribution from an Archer MSA.
12. Sec. 220(h)	A trustee or custodian of an MSA (Archer MSA or Medicare+Choice MSA) must provide certain information concerning the MSA to the account holder by January 31 following the calendar year to which the information relates. In addition, MSA contribution information must be furnished to the account holder, and Form 5498-SA filed with the IRS, by May 31 following the calendar year to which the information relates.
13. Sec. 223(f)(5)	A rollover contribution to a Health Savings Accounts (HSA) must be made no later than the 60th day after the day on which the account beneficiary receives a payment or distribution from a HSA.

Statute or Regulation	Act Postponed
14. Sec. 223(h)	A trustee or custodian of a HSA must provide certain information concerning the HSA to the account beneficiary by January 31 following the calendar year to which the information relates. In addition, HSA contribution information must be furnished to the account beneficiary, and Form 5498-SA filed with the IRS, by May 31 following the calendar year to which the information relates.
15. Secs. 401(a)(9), 403(a)(1), 403(b)(10), 408(a)(6), 408(b)(3) and 457(d)(2), and Treas. Reg. § 1.401(a)(9)-4 & 1.401(a)(9)-8, Q&A-2	The first required minimum distribution from plans subject to the rules in section 401(a)(9) must be made no later than the required beginning date. Subsequent required minimum distributions must be made by the end of each distribution calendar year.
16. Sec. 401(a)(28)(B)(i)	A qualified participant in an ESOP (as defined in section 401(a)(28)(B)(iii)) may elect within 90 days after the close of each plan year in the qualified election period (as defined in section 401(a)(28)(B)(iv)) to direct the plan as to the investment of at least 25 percent of the participant's account in the plan (50 percent in the case of the last election).
17. Sec. 401(a)(28)(B)(ii)	A plan must distribute the portion of the participant's account covered by an election under section 401(a)(28)(B)(i) within 90 days after the period during which an election can be made; or the plan must offer at least 3 investment options (not inconsistent with regulations prescribed by the Secretary) to each participant making the election under section 401(a)(28)(B)(i) and within 90 days after the period during which the election may be made, the plan must invest the portion of the participant's account in accordance with the participant's election.
18. Sec. 401(a)(30) and Treas. Reg. § 1.401(a)-30 and § 1.402(g)-1	Excess deferrals for a calendar year, plus income attributable to the excess, must be distributed no later than the first April 15 following the calendar year.
19. Sec. 401(b) and Treas. Reg. § 1.401(b)-1	A retirement plan that fails to satisfy the requirements of section 401(a) or section 403(a) on any day because of a disqualifying provision will be treated as satisfying such requirements on such day if, prior to the expiration of the applicable remedial amendment period, all plan provisions necessary to satisfy the requirements of section 401(a) or 403(a) are in effect and have been made effective for the whole of such period.
20. Sec. 401(k)(8)	A cash or deferred arrangement must distribute excess contributions for a plan year, plus income attributable to the excess, pursuant to the terms of the arrangement no later than the close of the following plan year.
21. Sec. 401(m)(6)	A plan subject to section 401(m) must distribute excess aggregate contributions for a plan year, plus income attributable to the excess, pursuant to the terms of the plan no later than the close of the following plan year.
22. Secs. 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16)(B)	An eligible rollover distribution may be rolled over to an eligible retirement plan no later than the 60th day following the day the distributee received the distributed property. A similar rule applies to IRAs.
23. Sec. 402(g)(2)(A) and Treas. Reg. § 1.402(g)-1	An individual with excess deferrals for a taxable year must notify a plan, not later than a specified date following the taxable year that excess deferrals have been contributed to that plan for the taxable year. A distribution of excess deferrals identified by the individual, plus income attributable to the excess, must be accomplished no later than the first April 15 following the taxable year of the excess.
24. Secs. 404(a)(6), 404(h)(1)(B), and 404(m)(2)	A contribution to a qualified retirement plan (other than an individual retirement account) shall be deemed to have been made by the taxpayer on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed for filing the return for such taxable year.
25. Sec. 404(k)(2)(A)(ii)	An ESOP receiving dividends on stock of the C corporation maintaining the plan must distribute the dividend in cash to participants or beneficiaries not later than 90 days after the close of the plan year in which the dividend was paid.
26. Sec. 408(d)(4)	A distribution of any contribution made for a taxable year to an individual retirement or for an individual retirement annuity shall be included in gross income unless such distribution (and attributable earnings) is received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year.
27. Sec. 408A(d)(6)(A)	If, on or before the date prescribed by law (including extensions of time) for filing the taxpayer's return for such taxable year, a taxpayer transfers in a trustee-to-trustee transfer any contribution to an individual retirement plan made during such taxable year from such plan to any other individual retirement plan, then such contribution shall be treated as having been made to the transferee plan (and not the transferor plan).
28. Secs. 408(i) and 6047(c)	A trustee or issuer of an individual retirement arrangement (IRA) must provide certain information concerning the IRA to the IRA owner by January 31 following the calendar year to which the information relates. In addition, IRA contribution information must be furnished to the owner, and Form 5498 filed with the IRS, by May 31 following the calendar year to which the information relates.
29. Sec. 409(h)(4)	An employer required to repurchase employer securities under section 409(h)(1)(B) must provide a put option for a period of at least 60 days following the date of distribution of employer securities to a participant, and if the put option is not exercised, for an additional 60-day period in the following plan year. A participant who receives a distribution of employer securities under section

Statute or Regulation	Act Postponed
	409(h)(1)(B) must exercise the put option provided by that section within a period of at least 60 days following the date of distribution, or if the put option is not exercised within that period, for an additional 60-day period in the following plan year.
30. Sec. 409(h)(5)	An employer required to repurchase employer securities distributed as part of a total distribution must pay for the securities in substantially equal periodic payments (at least annually) over a period beginning not later than 30 days after the exercise of the put option and not exceeding 5 years.
31. Sec. 409(h)(6)	An employer required to repurchase employer securities distributed as part of an installment distribution must pay for the securities not later than 30 days after the exercise of the put option under section 409(h)(4).
32. Sec. 409(o)	An ESOP must commence the distribution of a participant's account balance, if the participant elects, not later than 1 year after the close of the plan year — i) in which the participant separates from service by reason of attaining normal retirement age under the plan, death or disability; or ii) which is the 5th plan year following the plan year in which the participant otherwise separates from service (except if the participant is reemployed before distribution is required to begin).
33. Sec. 1042(a)(2)	A taxpayer must purchase qualified replacement property (defined in section 1042(c)(4)) within the replacement period, defined in section 1042(c)(3) as the period which begins 3 months before the date of the sale of qualified securities to an ESOP and ends 12 months after the date of such sale.
34. Sec. 4972(c)(3)	Nondeductible plan contributions must be distributed prior to a certain date to avoid a 10 percent tax.
35. Sec. 4979 and Treas. Reg. § 54.4979-1	A 10 percent tax on the amount of excess contributions and excess aggregate contributions under a plan for a plan year will be imposed unless the excess, plus income attributable to the excess is distributed (or, if forfeitable, forfeited) no later than $2^1/_2$-months after the close of the plan year. In the case of an employer maintaining a SARSEP, employees must be notified of the excess by the employer within the $2^1/_2$-month period to avoid the tax.
36. Secs. 6033, 6039D, 6047, 6057, 6058, and 6059	Form 5500, *Annual Return/Report of Employee Benefit Plan*, and Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*, which are used to report annual information concerning employee benefit plans and fringe benefit plans, must be filed by a specified time.
	General Advice Affected filers are advised to follow the instructions accompanying the Form 5500 series (or other guidance published on the postponement) regarding how to file the forms when postponements are granted pursuant to section 7508 or section 7508A.
	Combat Zone Postponements under Section 7508 Individual taxpayers who meet the requirements of section 7508 are entitled to a postponement of time to file the Form 5500 or Form 5500-EZ under section 7508. The postponement of the Form 5500 series filing due date under section 7508 will also be permitted by the Department of Labor and the Pension Benefit Guaranty Corporation (PBGC) for similarly situated individuals who are plan administrators.
	Postponements for Presidentially-Declared Disasters and Terroristic or Military Actions under Section 7508A In the case of "affected taxpayers," as defined in section 301.7508A-1(d), the IRS may permit a postponement of the filing of the Form 5500 or Form 5500-EZ. Taxpayers who are unable to obtain on a timely basis information necessary for completing the forms from a bank, insurance company, or any other service provider because such service providers' operations are located in a covered disaster area will be treated as "affected taxpayers." Whatever postponement of the Form 5500 series filing due date is permitted by the IRS under section 7508A will also be permitted by the Department of Labor and PBGC for similarly situated plan administrators and direct filing entities.
37. Rev. Proc. 2006-27, Sections 9.02(1) and (2)	The correction period for self-correction of operational failures is the last day of the second plan year following the plan year for which the failure occurred. The correction period for self-correction of operational failures for transferred assets does not end until the last day of the first plan year that begins after the corporate merger, acquisition, or other similar employer transaction.
38. Rev. Proc. 2006-27, 2003-44, Section 12.07	If the submission involves a plan with transferred assets and no new incidents of the failures in the submission occurred after the end of the second plan year that begins after the corporate merger, acquisition, or other similar employer transaction, the plan sponsor may calculate the amount of plan assets and number of plan participants based on the Form 5500 information that would have been filed by the plan sponsor for the plan year that includes the employer transaction if the transferred assets were maintained as a separate plan.
39. Rev. Proc. 2006-27, Section 14.03	If an examination involves a plan with transferred assets and the IRS determines that no new incidents of the failures that relate to the transferred assets occurred after the end of the second plan year that begins after the corporate merger, acquisition, or other similar employer transaction, the sanction under Audit CAP will not exceed the sanction that would apply if the transferred assets were maintained as a separate plan.

SECTION 9. ESTATE, GIFT AND TRUST ISSUES

Statute or Regulation	Act Postponed
1. Sec. 643(g)	The trustee may elect to treat certain payments of estimated tax as paid by the beneficiary. The election shall be made on or before the 65th day after the close of the taxable year of the trust.
2. Sec. 645 and Treas. Reg. § 1.645-1(c)	An election to treat a qualified revocable trust as part of the decedent's estate must be made by filing Form 8855, *Election To Treat a Qualified Revocable Trust as Part of an Estate*, by the due date (including extensions) of the estate's Federal income tax return for the estate's first taxable year, if there is an executor, or by the due date (including extensions) of the trust's Federal income tax

Statute or Regulation	Act Postponed
	return for the trust's first taxable year (treating the trust as an estate), if there is no executor.
3. Sec. 663(b) and Treas. Reg. § 1.663(b)-2	The fiduciary of a trust or estate may elect to treat any amount properly paid or credited to a beneficiary within the first 65 days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year. If a return is required to be filed for the taxable year for which the election is made, the election shall be made on such return no later than the time for making such return (including extensions). If no return is required to be filed, the election shall be made in a separate statement filed with the internal revenue office with which a return would have been filed, no later than the time for making a return (including extensions).
4. Sec. 2011(c)	The executor of a decedent's estate must file a claim for a credit for state estate, inheritance, legacy or succession taxes by filing a claim within 4 years of filing Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. (Section 2011 does not apply to estates of decedents dying after December 31, 2004; see section 2058).
5. Sec. 2014(e)	The executor of a decedent's estate must file a claim for foreign death taxes within 4 years of filing Form 706.
6. Sec. 2016 and Treas. Reg. § 20.2016-1	If an executor of a decedent's estate (or any other person) receives a refund of any state or foreign death taxes claimed as a credit on Form 706, the IRS must be notified within 30 days of receipt. (Section 2016 is amended effective for estates of decedents dying after December 31, 2004; see section 2058).
7. Sec. 2031(c)	If an executor of a decedent's estate elects on Form 706 to exclude a portion of the value of land that is subject to a qualified conservation easement, agreements relating to development rights must be implemented within 2 years after the date of the decedent's death.
8. Sec. 2032(d)	The executor of a decedent's estate may elect an alternate valuation on a late filed Form 706 if the Form 706 is not filed later than 1 year after the due date.
9. Sec. 2032A(c)(7)	A qualified heir, with respect to specially valued property, is provided a two-year grace period immediately following the date of the decedent's death in which the failure by the qualified heir to begin using the property in a qualified use will not be considered a cessation of qualified use and therefore will not trigger additional estate tax.
10. Sec. 2032A(d)(3)	The executor of a decedent's estate has 90 days after notification of incomplete information/signatures to provide the information/signatures to the IRS regarding an election on Form 706 with respect to specially valued property.
11. Sec. 2046	A taxpayer may make a qualified disclaimer no later than 9 months after the date on which the transfer creating the interest is made, or the date the person attains age 21.
12. Sec. 2053(d) and Treas. Reg. §§ 20.2053-9(c) and 10(c)	If the executor of a decedent's estate elects to take a deduction for state and foreign death tax imposed upon a transfer for charitable or other uses, the executor must file a written notification to that effect with the IRS before expiration of the period of limitations on assessments (generally 3 years). (Section 2053 is amended effective for estates of decedents dying after December 31, 2004, to apply only with respect to foreign death taxes).
13. Sec. 2055(e)(3)	A party in interest must commence a judicial proceeding to change an interest into a qualified interest no later than the 90th day after the estate tax return (Form 706) is required to be filed or, if no return is required, the last date for filing the income tax return for the first taxable year of the trust.
14. Sec. 2056(d)	A qualified domestic trust (QDOT) election must be made on Form 706, Schedule M, and the property must be transferred to the trust before the date on which the return is made. Any reformation to determine if a trust is a QDOT requires that the judicial proceeding be commenced on or before the due date for filing the return.
15. Sec. 2056A(b)(2)	The trustee of a QDOT must file a claim for refund of excess tax no later than 1 year after the date of final determination of the decedent's estate tax liability.
16. Sec. 2057(i)(3)(G)	A qualified heir, with respect to qualified family owned business, has a two-year grace period immediately following the date of the decedent's death in which the failure by the qualified heir to begin using the property in a qualified use will not be considered a cessation of qualified use and therefore will not trigger additional estate tax. (The section 2057 election is not available to estates of decedents dying after December 31, 2004).
17. Sec. 2057(i)(3)(H)	The executor of a decedent's estate has 90 days after notification of incomplete information/signatures to provide the information/signatures to the IRS regarding an election on Form 706 with respect to specially valued property.
18. Sec. 2058(b)	The executor of a decedent's estate may deduct estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia from the decedent's gross estate. With certain exceptions, the deduction is only allowed provided the taxes are actually paid and the deduction claimed within 4 years of filing Form 706.
19. Sec. 2516	The IRS will treat certain transfers as made for full and adequate consideration in money or money's worth where husband and wife enter into a written agreement relative to their marital and property rights and divorce actually occurs within the 3-year period beginning on the date 1 year before such agreement is entered into.
20. Sec. 2518(b)	A taxpayer may make a qualified disclaimer no later than 9 months after the date on which the transfer creating the interest is made, or the date the person attains age 21.

SECTION 10. EXEMPT ORGANIZATION ISSUES

Statute or Regulation	Act Postponed
1. Sec. 501(h)	Under section 501(h), certain eligible 501(c)(3) organizations may elect on Form 5768, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation*, to have their legislative activities measured solely by expenditures. Form 5768 is effective beginning with a taxable period, provided it is filed before the end of the organization's taxable period.

Statute or Regulation	Act Postponed
2. Sec. 505(c)(1)	An organization must give notice by filing Form 1024, *Application for Recognition of Exemption Under Section 501(a)*, to be recognized as an organization exempt under section 501(c)(9) or section 501(c)(17). Generally, if the exemption is to apply for any period before the giving of the notice, section 1.505(c)-1T, Q&A-6, of the regulations requires that Form 1024 be filed within 15 months from the end of the month in which the organization was organized.
3. Sec. 508 and Treas. Reg. § 1.508-1	A purported section 501(c)(3) organization must generally file Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, to qualify for exemption. Generally, if the exemption is to apply for any period before the giving of the notice, the Form 1023 must be filed within 15 months from the end of the month in which the organization was organized.
4. Sec. 527(i)(2)	Certain political organizations shall not be treated as tax-exempt section 527 organizations unless each such organization electronically files a notice (Form 8871, *Political Organization Notice of Section 527 Status*) not less than 24 hours after the date on which the organization is established, or, in the case of a material change in the information required, not later than 30 days after such material change.
5. Sec. 527(j)(2)	Under section 527(j)(2), certain tax-exempt political organizations that accept contributions or make expenditures for an exempt function under section 527 during a calendar year are required to file periodic reports on Form 8872, *Political Organization Report of Contributions and Expenditures*, beginning with the first month or quarter in which they accept contributions or make expenditures, unless excepted. In addition, tax-exempt political organizations that make contributions or expenditures with respect to an election for federal office may be required to file pre-election reports for that election. A tax-exempt political organization that does not file the required Form 8872, or that fails to include the required information, must pay an amount calculated by multiplying the amount of the contributions or expenditures that are not disclosed by the highest corporate tax rate.
6. Sec. 6033(g)(1) and Treas. Reg. § 1.6033-2(e)	Annual information returns, Forms 990, *Return of Organization Exempt From Income Tax*, of certain tax-exempt political organizations described under section 527 must be filed on or before the 15th day of the 5th month following the close of the taxable year.
7. Sec. 6034 and Treas. Reg. § 1.6034-1(c)	Annual information returns, Forms 1041-A, *U.S. Information Return Trust Accumulation of Charitable Amounts*, of trusts claiming charitable or other deductions under section 642(c) must be filed on or before the 15th day of the 4th month following the close of the taxable year of the trust.
8. Sec. 6072(e) and Treas. Reg. § 1.6033-2(e)	Annual returns of organizations exempt or treated in the same manner as organizations exempt from tax under section 501(a) must be filed on or before the 15th day of the 5th month following the close of the taxable year.
9. Rev. Proc. 80-27, Section 6.01	The central organization of a group ruling is required to report information regarding the status of members of the group annually (at least 90 days before the close of its annual accounting period).

SECTION 11. EXCISE TAX ISSUES

Statute or Regulation	Act Postponed
1. Treas. Reg. § 48.4101-1(h)(v)	A registrant must notify the IRS of any change in the information a registrant has submitted within 10 days.
2. Sec. 4101(d) and Treas. Reg. § 48.4101-2	Each information return under section 4101(d) must be filed by the last day of the first month following the month for which the report is made.
3. Sec. 4221(b) and Treas. Reg. § 48.4221-2(c)	A manufacturer is allowed to make a tax-free sale of articles for resale to a second purchaser for use in further manufacture. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.
4. Sec. 4221(b) and Treas. Reg. § 48.4221-3(c)	A manufacturer is allowed to make a tax-free sale of articles for export. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.
5. Sec. 4221(e)(2)(A) and Treas. Reg. § 48.4221-7(c)	A manufacturer is allowed to make a tax-free sale of tires for use by the purchaser in connection with the sale of another article manufactured or produced by the purchaser. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.

SECTION 12. INTERNATIONAL ISSUES

Statute or Regulation	Act Postponed
1. Sec. 482 and Treas. Reg. § 1.482-1(g)(4)(ii)(C)	A claim for a setoff of a section 482 allocation by the IRS must be filed within 30 days of either the date of the IRS's letter transmitting an examination report with notice of the proposed adjustment or the date of a notice of deficiency.
2. Sec. 482 and Treas. Reg. § 1.482-1(j)(2)	A claim for retroactive application of the final section 482 regulations, otherwise effective only for taxable years beginning after October 6, 1994, must be filed prior to the expiration of the statute of limitations for the year for which retroactive application is sought.

Statute or Regulation	Act Postponed
3. Sec. 482 and Treas. Reg. § 1.482-7(j)(2)	A participant in a cost-sharing arrangement must provide documentation regarding the arrangement, as well as documentation specified in sections 1.482-7(b)(4) and 1.482-7(c)(1), within 30 days of a request by the IRS.
4. Treas. Reg. § 1.882-5(d)(2)(ii)(A)(2)	Liabilities of a foreign corporation that is not a bank must be entered on a set of books at a time reasonably contemporaneous with the time the liabilities are incurred.
5. Treas. Reg. § 1.882-5(d)(2)(iii)(A)(1)	Liabilities of foreign corporations that are engaged in a banking business must be entered on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred.
6. Treas. Reg. § 1.884-2T(b)(3)(i)	Requirement that marketable securities be identified on the books of a U.S. trade or business within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets. This requirement applies when a taxpayer has elected to be treated as remaining engaged in a U.S. trade or business for branch profits tax purposes.
7. Treas. Reg. § 1.884-4(b)(3)(ii)(B)	Requirement that a foreign corporation which identifies liabilities as giving rise to U.S. branch interest, send a statement to the recipients of such interest within two months of the end of the calendar year in which the interest was paid, stating that such interest was U.S. source income (if the corporation did not make a return pursuant to section 6049 with respect to the interest payment).
8. Treas. Reg. § 1.922-1(i) (Q&A-13)	The quarterly income statements for the first three quarters of the FSC year must be maintained at the FSC's office no later than 90 days after the end of the quarter. The quarterly income statement for the fourth quarter of the FSC year, the final year-end income statement, the year-end balance sheet, and the final invoices (or summaries) or statements of account must be maintained at the FSC's office no later than the due date, including extensions, of the FSC tax return for the applicable taxable year.
9. Sec. 922(a)(1)(E) and Treas. Reg. § 1.922-1(j) (Q&A-19)	The FSC must appoint a new non-U.S. resident director within 30 days of the date of death, resignation, or removal of the former director, in the event that the sole non-U.S. resident director of a FSC dies, resigns, or is removed.
10. Sec. 924(b)(2)(B) and Treas. Reg. § 1.924(a)-1T(j)(2)(i)	A taxpayer must execute an agreement regarding unequal apportionment at a time when at least 12 months remain in the period of limitations (including extensions) for assessment of tax with respect to each shareholder of the small FSC in order to apportion unequally among shareholders of a small FSC the $5 million foreign trading gross receipts used to determine exempt foreign trade income.
11. Sec. 924(c)(2) and Treas. Reg. § 1.924(c)-1(c)(4)	The FSC must open a new qualifying foreign bank account within 30 days of the date of termination of the original bank account, if a FSC's qualifying foreign bank account terminates during the taxable year due to circumstances beyond the control of the FSC.
12. Sec. 924(c)(3) and Treas. Reg. § 1.924(c)-1(d)(1)	The FSC must transfer funds from its foreign bank account to its U.S. bank account, equal to the dividends, salaries, or fees disbursed, and such transfer must take place within 12 months of the date of the original disbursement from the U.S. bank account, if dividends, salaries, or fees are disbursed from a FSC's U.S. bank account.
13. Sec. 924(c)(3) and Treas. Reg. § 1.924(c)-1(d)(2)	The FSC must reimburse from its own bank account any dividends or other expenses that are paid by a related person, on or before the due date (including extensions) of the FSC's tax return for the taxable year to which the reimbursement relates.
14. Sec. 924(c)(3) and Treas. Reg. § 1.924(c)-1(d)(3)	If the Commissioner determines that the taxpayer acted in good faith, the taxpayer may comply with the reimbursement requirement by reimbursing the funds within 90 days of the date of the Commissioner's determination, notwithstanding a taxpayer's failure to meet the return-filing-date reimbursement deadline in section 1.924(c)-1(d)(2).
15. Sec. 924(e)(4) and Treas. Reg. § 1.924(e)-1(d)(2)(iii)	If a payment with respect to a transaction is made directly to the FSC or the related supplier in the United States, the funds must be transferred to and received by the FSC bank account outside the United States no later than 35 days after the receipt of good funds (*i.e.*, date of check clearance) on the transaction.
16. Temp. Treas. Reg. § 1.925(a)-1T(e)(4)	A FSC and its related supplier may redetermine a transfer pricing method, the amount of foreign trading gross receipts, and costs and expenses, provided such redetermination occurs before the expiration of the statute of limitations for claims for refund for both the FSC and related supplier, and provided the statute of limitations for assessment applicable to the party that has a deficiency in tax on account of the redetermination is open. See Treas. Reg. § 1.925(a)-1(c)(8)(i) for time limitations with respect to FSC administrative pricing grouping redeterminations and for a cross-reference to section 1.925(a)-1T(e)(4).
17. Sec. 927(f)(3)(A) and Treas. Reg. § 1.927(f)-1(b) (Q&A-12)	A corporation may terminate its election to be treated as a FSC or a small FSC by revoking the election during the first 90 days of the FSC taxable year (other than the first year in which the election is effective) in which the revocation was to take effect.
18. Sec. 927 and Temp. Treas. Reg. § 1.927(a)-1T (d)(2)(i)(B)	A taxpayer may satisfy the destination test with respect to property sold or leased by a seller or lessor if such property is delivered by the seller or lessor (or an agent of the seller or lessor) within the United States to a purchaser or lessee, if the property is ultimately delivered outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within one year after the sale or lease.
19. Sec. 927 and	A taxpayer that claims FSC commission deductions must designate the sales, leases, or rentals subject to the FSC commission

Statute or Regulation	Act Postponed
Temp. Treas. Reg. § 1.927(b)-1T(e)(2)(i)	agreement no later than the due date (as extended) of the tax return of the FSC for the taxable year in which the transaction(s) occurred.
20. Sec. 927 and Treas. Reg. § 1.927(f)-1(a) (Q&A 4)	A transferee or other recipient of shares in the corporation (other than a shareholder that previously consented to the election) must consent to be bound by the prior election within 90 days of the first day of the FSC's taxable year to preserve the status of a corporation that previously qualified as a FSC or as a small FSC.
21. Sec. 936 and Treas. Reg. § 1.936-11	A taxpayer that elects retroactive application of the regulation regarding separate lines of business for taxable years beginning after December 31, 1995, must elect to do so prior to the expiration of the statute of limitations for the year in question.
22. Treas. Reg. §§ 1.964-1T(c)(3)	An election, adoption or change in a method of accounting or tax year on behalf of a CFC or noncontrolled section 902 corporation by its controlling domestic shareholders requires the filing of a statement with the shareholder's return for its year with or within which ends the foreign corporation's taxable year for which the election is made or the method or tax year is adopted or changed, and the filing of a written notice on or before the filing date of the shareholder's return.
23. Sec. 982(c)(2)(A)	Any person to whom a formal document request is mailed shall have the right to bring a proceeding to quash such request not later than the 90th day after the day such request was mailed.
24. Treas. Reg. § 1.988-1(a)(7)(ii)	An election to have section 1.988-1(a)(2)(iii) apply to regulated futures contracts and nonequity options must be made on or before the first day of the taxable year, or if later, on or before the first day during such taxable year on which the taxpayer holds a contract described in section 988(c)(1)(D)(ii) and section 1.988-1(a)(7)(ii). A late election may be made within 30 days after the time prescribed for the election.
25. Sec. 988(c)(1)(E)(iii)(V) (qualified fund) and Treas. Reg. § 1.988-1(a)(8)(i)(E)	A qualified fund election must be made on or before the first day of the taxable year, or if later, on or before the first day during such taxable year on which the partnership holds an instrument described in section 988(c)(1)(E)(i).
26. Treas. Reg. § 1.988-3(b)	An election to treat (under certain circumstances) any gain or loss recognized on a contract described in section 1.988-2(d)(1) as capital gain or loss must be made by clearly identifying such transaction on taxpayer's books and records on the date the transaction is entered into.
27. Treas. Reg. § 1.988-5(a)(8)(i)	Taxpayer must establish a record, and before the close of the date the hedge is entered into, the taxpayer must enter into the record for each qualified hedging transaction the information contained in sections 1.988-5(a)(8)(i)(A) through (E).
28. Treas. Reg. § 1.988-5(b)(3)(i)	Taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge.
29. Treas. Reg. § 1.988-5(c)(2)	Taxpayer must identify a hedge and underlying stock or security under the rules of section 1.988-5(b)(3).
30. Sec. 991	A corporation that elects IC-DISC treatment (other than in the corporation's first taxable year) must file Form 4876-A, *Election To Be Treated as an Interest Charge DISC*, with the regional service center during the 90-day period prior to the beginning of the tax year in which the election is to take effect.
31. Sec. 991 and Treas. Reg. § 1.991-2(g)(2)	A corporation that filed a tax return as a DISC, but subsequently determines that it does not wish to be treated as a DISC, must notify the Commissioner more than 30 days before the expiration of period of limitations on assessment applicable to the tax year.
32. Sec. 992 and Treas. Reg. § 1.992-2(a)(1)(i)	A qualifying corporation must file Form 4876-A or attachments thereto, containing the consent of every shareholder of the corporation to be treated as a DISC as of the beginning of the corporation's first taxable year.
33. Sec. 992 and Treas. Reg. § 1.992-2(e)(2)	A corporation seeking to revoke a prior election to be treated as a DISC, must file a statement within the first 90 days of the taxable year in which the revocation is to take effect with the service center with which it filed the election or, if the corporation filed an annual information return, by filing the statement at the service center with which it filed its most recent annual information return.
34. Sec. 992 and Treas. Reg. § 1.992-3(c)(3)	A DISC that makes a deficiency distribution with respect to the 95 percent of gross receipts test or the 95 percent assets test, or both tests, for a particular taxable year, must make such distribution within 90 days of the date of the first written notification from the IRS that the DISC failed to satisfy such test(s).
35. Sec. 993 and Treas. Reg. § 1.993-3(d)(2)(i)(b)	In certain cases, property may not qualify as export property for DISC purposes unless, among other things, such property is ultimately delivered, directly used, or directly consumed outside the U.S. within one year of the date of sale or lease of the property.
36. Sec. 1445 Treas. Reg. § 1.1445-1	Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, must be filed by a buyer or other transferee of a U.S. real property interest, and a corporation, partnership, or fiduciary that is required to withhold tax. The amount withheld is to be transmitted with Form 8288, which is generally to be filed by the 20th day after the date of transfer.
37. Sec. 1446	All partnerships with effectively connected gross income allocable to a foreign partner in any tax year must file Forms 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*, and 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*, on or before the 15th day of the 4th month following the close of the partnership's taxable year.

Statute or Regulation	Act Postponed
38. Sec. 1446	Form 8813, *Partnership Withholding Tax Payment Voucher (Section 1446)*, is used to pay the withholding tax under section 1446 for all partnerships with effectively connected gross income allocable to a foreign partner in any tax year. Form 8813, *Partnership Withholding Tax Payment Voucher (Section 1446)*, must accompany each payment of section 1446 tax made during the partnership's taxable year. Form 8813 is to be filed on or before the 15th day of the 4th, 6th, 9th, and 12th months of the partnership's taxable year for U.S. income tax purposes.
39. Sec. 6038A(d)(2) and Treas. Reg. § 1.6038A-4(d)(1)	A reporting corporation must cure any failure to furnish information or failure to maintain records within 90 days after the IRS gives notice of the failure to avoid the continuation penalty.
40. Sec. 6038A(d)(2) and Treas. Reg. § 1.6038A-4(d)(1)	A reporting corporation must cure any failure to furnish information or failure to maintain records before the beginning of each 30-day period after expiration of the initial 90-day period to avoid additional continuation penalties.
41. Sec. 6038A(a) and Treas. Reg. § 1.6038A-2(d)	A reporting corporation must file a duplicate Form 5472 at the same time it files its income tax return unless Form 5472 is filed electronically.
42. Sec. 6038A(e)(1) and Treas. Reg. § 1.6038A-5(b)	A reporting corporation must furnish an authorization of agent within 30 days of a request by the IRS to avoid a penalty.
43. Sec. 6038A(e)(4)(A)	A reporting corporation must commence any proceeding to quash a summons filed by the IRS in connection with an information request within 90 days of the date the summons is issued.
44. Sec. 6038A(e)(4)(B)	A reporting corporation must commence any proceeding to review the IRS's determination of noncompliance with a summons within 90 days of the IRS's notice of noncompliance.
45. Sec. 6038A and Treas. Reg. § 1.6038A-3(b)(3)	A reporting corporation must supply an English translation of records provided pursuant to a request for production within 30 days of a request by the IRS for a translation to avoid a penalty.
46. Sec. 6038A and Treas. Reg. § 1.6038A-3(f)(2)	A reporting corporation must, within 60 days of a request by the IRS for records maintained outside the United States, either provide the records to the IRS, or move them to the United States and provide the IRS with an index to the records to avoid a penalty.
47. Sec. 6038A and Treas. Reg. § 1.6038A-3(f)(2)(i)	A reporting corporation must supply English translations of documents maintained outside the United States within 30 days of a request by the IRS for translation to avoid a penalty.
48. Sec. 6038A and Treas. Reg. § 1.6038A-3(f)(4)	A reporting corporation must request an extension of time to produce or translate documents maintained outside the United States beyond the period specified in the regulations within 30 days of a request by the IRS to avoid a penalty.
49. Secs. 6038, 6038B, and 6046A	The filing of Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, for those taxpayers who do not have to file an income tax return. The form is due at the time that an income tax return would have been due had the taxpayer been required to file an income tax return or at the time any required information return is due.
50. Secs. 6039F and 6048	Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, must be filed by the due date of the U.S. person's income tax return, including extensions.
51. Sec. 6662(e) and Treas. Reg. § 1.6662-6(d)(2)(iii)(A)	A taxpayer must provide, within 30 days of a request by the IRS, specified "principal documents" regarding the taxpayer's selection and application of transfer pricing method to avoid potential penalties in the event of a final transfer pricing adjustment by the IRS. See also Treas. Reg. § 1.6662-6(d)(2)(iii)(C) (similar requirement re: background documents).

SECTION 13. PARTNERSHIP AND S CORPORATION ISSUES

Statute or Regulation	Act Postponed
1. Treas. Reg. §§ 1.442-1(b)(1) and (3) and 1.706-1(b)(8)	A partnership may obtain approval of the Commissioner to adopt, change or retain an annual accounting period by filing Form 1128, *Application To Adopt, Change, or Retain a Tax Year*, within such time as provided in administrative procedures published by the Commissioner. See Rev. Procs. 2006-46, 2006-45 I.R.B. 859, and 2002-39, 2002-1 C.B. 1046.
2. Treas. Reg. § 1.743-1(k)(2)	A transferee that acquires, by sale or exchange, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange. A transferee that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner.
3. Treas. Reg. § 1.754-1(c)(1)	Generally, a partnership may revoke a section 754 election by filing the revocation no later than 30 days after the close of the partnership taxable year with respect to which the revocation is intended to take effect.

Statute or Regulation	Act Postponed
4. Treas. Reg. § 1.761-2(b)(3)	A partnership may generally elect to be excluded from subchapter K. The election will be effective unless within 90 days after the formation of the organization any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization and also advises the Commissioner that he has so notified all other members of the organization. In addition, an application to revoke an election to be excluded from subchapter K must be submitted no later than 30 days after the beginning of the first taxable year to which the revocation is to apply.
5. Treas. Reg. § 1.761-2(c)	A partnership requesting permission to be excluded from certain provisions of subchapter K must submit the request to the Commissioner no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired.
6. Sec. 1361(e)	In general, the trustee of the electing small business trust (ESBT) must file the ESBT election within the 2-month and 16-day period beginning on the day the stock is transferred to the trust. See Treas. Reg. § 1.1361-1(m)(2)(ii).
7. Treas. Reg. § 1.1361-1(j)(6)	The current income beneficiary of a qualified subchapter S trust (QSST) must make a QSST election within the 2-month and 16-day period from one of the dates prescribed in section 1.1361-1(j)(6)(iii).
8. Treas. Reg. § 1.1361-1(j)(10)	The successive income beneficiary of a QSST may affirmatively refuse to consent to the QSST election. The beneficiary must sign the statement and file the statement with the IRS within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary.
9. Treas. Reg. § 1.1361-3(a)(4)	If an S corporation elects to treat an eligible subsidiary as a qualified subchapter S subsidiary (QSUB), the election cannot be effective more than 2 months and 15 days prior to the date of filing the election.
10. Treas. Reg. § 1.1361-3(b)(2)	An S corporation may revoke a QSUB election by filing a statement with the service center. The effective date of a revocation of a QSUB election cannot be more than 2 months and 15 days prior to the filing date of the revocation.
11. Treas. Reg. § 1.1362-2(a)(2), (4)	If a corporation revokes its subchapter S election after the first $2^1/_2$-months of its taxable year, the revocation will not be effective until the following taxable year. An S corporation may rescind a revocation of an S election at any time before the revocation becomes effective.
12. Sec. 1362(b)(1)	An election under section 1362(a) to be an S corporation may be made by a small business corporation for any taxable year at any time during the preceding taxable year, or at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year.
13. Rev. Proc. 2003-43	This revenue procedure provides a simplified method for taxpayers requesting relief for late S corporation elections, Qualified Subchapter S Subsidiary (QSUB) elections, Qualified Subchapter S Trust (QSST) elections, and Electing Small Business Trust (ESBT) elections. Generally, this revenue procedure provides that certain eligible entities may file late elections within 24 months of the due date of the election.
14. Rev. Proc. 2004-48	This revenue procedure provides a simplified method for taxpayers to request relief for a late S corporation election and a late corporate classification election which was intended to be effective on the same date that the S corporation election was intended to be effective. This revenue procedure provides that within 6 months after the due date for the tax return, excluding extensions, for the first year the entity intended to be an S corporation, the corporation must file a properly completed Form 2553, *Election by a Small Business Corporation*, with the applicable service center.
15. Sec. 1378(b) and Treas. Reg. § 1.1378-1(c)	An S or electing S corporation may obtain the approval of the Commissioner to adopt, change or retain an annual accounting period by filing Form 1128, *Application To Adopt, Change, or Retain a Tax Year*, within such time as is provided in administrative procedures published by the Commissioner. See Rev. Procs. 2006-46 and 2002-39.

SECTION 14. PROCEDURE & ADMINISTRATION ISSUES

.01 Bankruptcy and Collection

Statute or Regulation	Act Postponed
1. Treas. Reg. § 301.6036-1(a)(2) and (3)	A court-appointed receiver or fiduciary in a non-bankruptcy receivership, a fiduciary in aid of foreclosure who takes possession of substantially all of the debtor's assets, or an assignee for benefit of creditors, must give written notice within ten days of his appointment to the IRS as to where the debtor will file his tax return.
2. Sec. 6320(a)(3)(B) and (c) and Treas. Reg. § 301.6320-1(b), (c) and (f)	A taxpayer has 30 days after receiving a notice of a lien to request a Collection Due Process (CDP) administrative hearing. After a determination at the CDP hearing, the taxpayer may appeal this determination within 30 days to the United States Tax Court or a United States district court.
3. Sec. 6330(a)(3)(B) and (d)(1) and Treas. Reg. § 301.6330-1(b), (c) and (f)	The taxpayer must request a Collections Due Process (CDP) administrative hearing within 30 days after the IRS sends notice of a proposed levy. After a determination at the CDP hearing, the taxpayer may appeal this determination within 30 days to the United States Tax Court or a United States district court.
4. Sec. 6331(k)(1) and Treas. Reg. § 301.7122-1(g)(2)	If a taxpayer submits a good-faith revision of a rejected offer in compromise within 30 days after the rejection, the Service will not levy to collect the liability before deciding whether to accept the revised offer.
5. Sec. 6331(k)(2) and Treas. Reg.	If, within 30 days following the rejection or termination of an installment agreement, the taxpayer files an appeal with the IRS Office of Appeals, no levy may be made while the rejection or termination is being considered by Appeals.

Statute or Regulation	Act Postponed
§ 301.6331-4(a)(1)	
6. Rev. Proc. 2005-34, Sec. 4.01	If the Service determines that a taxpayer is liable for the trust fund recovery penalty under section 6672, the Service will provide the taxpayer an opportunity to dispute the proposed assessment by appealing the proposed assessment within 60 days of the date on the notice (75 days if the notice is addressed to the taxpayer outside of the United States).
7. Sec. 7122(d)(2) and Treas. Reg. § 301.7122-1(f)(5)(i)	A taxpayer must request administrative review of a rejected offer in compromise within 30 days after the date on the letter of rejection.

.02 Information Returns

Statute or Regulation	Act Postponed
1. Sec. 6050I	Any person engaged in a trade or business receiving more than $10,000 cash in one transaction (or 2 or more related transactions) must file an information return, Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, by the 15th day after the date the cash was received. Additionally, a statement must be provided to the person with respect to whom the information is required to be furnished by Jan. 31st of the year following.
2. Sec. 6050K and Treas. Reg. 1.6050K-1(f)(2)	A partnership notified of an exchange after the partnership has filed its Form 1065 for the taxable year with respect to which the exchange should have been reported shall file its Form 8308 with the service center where its Form 1065 was filed on or before the 30th day after the partnership is notified of the exchange.
3. Sec. 6050L	Returns relating to certain dispositions of donated property, Forms 8282, *Donee Information Return*, must be filed within 125 days of the disposition.

.03 Miscellaneous

Statute or Regulation	Act Postponed
1. Sec. 1314(b)	A taxpayer may file a claim for refund or credit of tax based upon the mitigation provisions of sections 1311 through 1314 if, as of the date a determination (as defined in section 1313(a)) is made, one year remains on the period for filing a claim for refund.
2. Sec. 6015	A requesting spouse must request relief under section 6015 within 2 years of the first collection activity against the requesting spouse.
3. Sec. 6015(e)	A requesting spouse may petition the Tax Court to determine the appropriate relief under this section if such petition is filed not later than the close of the 90th day after the Service mails, by certified or registered mail, notice of the Service's final determination of relief available to the individual.
4. Sec. 6411	Taxpayers applying for a tentative carryback adjustment of the tax for the prior taxable year must file Form 1139, *Corporation Application for Tentative Refund*, (for corporations) or Form 1045, *Application for Tentative Refund*, (for entities other than corporations) within 12 months after the end of such taxable year that generates such net operating loss, net capital loss, or unused business credit from which the carryback results.
5. Sec. 6656(e)(2)	A taxpayer who is required to deposit taxes and fails to do so is subject to a penalty under section 6656. Under section 6656(e)(2), the taxpayer may, within 90 days of the date of the penalty notice, designate to which deposit period within a specified tax period the deposits should be applied.

SECTION 15. TAX CREDIT ISSUES

Statute or Regulation	Act Postponed
1. Sec. 42(e)(3)(A)(ii)	A taxpayer has a 24-month measuring period in which the requisite amount of rehabilitation expenditures has to be incurred in order to qualify for treatment as a separate new building.
2. Treas. Reg. § 1.42-5(c)(1)	The taxpayer must make certain certifications at least annually to the Agency.
3. Treas. Reg. § 1.42-5(c)(1)(iii)	The taxpayer must receive an annual income certification from each low-income tenant with documentation to support the certification.
4. Treas. Reg. § 1.42-8(a)(3)(v)	The taxpayer and an Agency may elect to use an appropriate percentage under section 42(b)(2)(A)(ii)(I) by notarizing a binding agreement by the 5th day following the end of the month in which the binding agreement was made.
5. Treas. Reg. § 1.42-8(b)(1)(vii)	The taxpayer and an Agency may elect an appropriate percentage under section 42(b)(2)(A)(ii)(II) by notarizing a binding agreement by the 5th day following the end of the month in which the tax-exempt bonds are issued.
6. Sec. 42(d)(2)(D)(ii)(IV)	In order to claim section 42 credits on an existing building, section 42(d)(2)(B)(ii)(I) requires that the building must have been placed in service at least ten years before the date the building was acquired by the taxpayer. A building is not considered placed in service for purposes of section 42(d)(2)(B)(ii) if the building is resold within a 12-month period after acquisition by foreclosure of any purchase-money security interest.
7. Sec. 42(g)(3)(A)	A building shall be treated as a qualified low-income building only if the project meets the minimum set aside requirement by the close of the first year of the credit period of the building.

Statute or Regulation	Act Postponed
8. Sec. 42(h)(6)(J)	A low-income housing agreement commitment must be in effect as of the beginning of the year for a building to receive credit. If such a commitment was not in effect, the taxpayer has a one-year period for correcting the failure.
9. Sec. 42(h)(1)(E) and (F)	The taxpayer's basis in the building project, as of the later of the date which is 6 months after the date the allocation was made or the close of the calendar year in which the allocation is made, must be more than 10 percent of the taxpayer's reasonably expected basis in the project.
10. Sec. 47(c)(1)(C) and Treas. Reg. § 1.48-12(b)(2)	A taxpayer has a 24- or 60-month measuring period in which the requisite amount of rehabilitation expenditures have to be incurred in order to satisfy the "substantial rehabilitation" test.
11. Treas. Reg. § 1.48-12(d)(7)	In the historic rehabilitation context, if the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the return on which the credit is claimed, the taxpayer must, prior to the last day of the 30th month, consent to extending the statute of limitations by submitting a written statement to the Service.
12. Sec. 51(d)(12)(A)(ii)(II) and 51A(d)(1)	An employer seeking the Work Opportunity Credit with respect to an individual must submit Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, to the State Employment Security Agency (State Workforce Agency) not later than the 28th day after the individual begins work for the employer.

SECTION 16. TAX-EXEMPT BOND ISSUES

Statute or Regulation	Act Postponed
1. Treas. Reg. § 1.25-4T(c)	On or before the date of distribution of mortgage credit certificates under a program or December 31, 1987, the issuer must file an election not to issue an amount of qualified mortgage bonds. An election may be revoked, in whole or on part, at any time during the calendar year in which the election was made.
2. Treas. Reg. §§ 1.141-12(d)(3) and 1.142-2(c)(2)	An issuer must provide notice to the Commissioner of the establishment of a defeasance escrow within 90 days of the date such defeasance escrow is established in accordance with sections 1.141-12(d)(1) or 1.142-2(c)(1).
3. Sec. 142(d)(7)	An operator of a multi-family housing project for which an election was made under section 142(d) must submit to the Secretary an annual certification as to whether such project continues to meet the requirements of section 142(d).
4. Sec. 142(f)(4) and Treas. Reg. § 1.142(f)(4)-1	A person engaged in the local furnishing of electric energy or gas (a local furnisher) that uses facilities financed with exempt facility bonds under section 142(a)(8) and expands its service area in a manner inconsistent with the requirements of sections 142(a)(8) and 142(f), may make an election to ensure that those bonds will continue to be treated as exempt facility bonds. The election must be filed with the IRS on or before 90 days after the date of the service area expansion that causes the bonds to cease to meet the applicable requirements.
5. Sec. 146(f) and Notice 89-12	If an issuing authority's volume cap for any calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during such calendar year by such authority, such authority may elect to treat all (or any portion) of such excess as a carryforward for 1 or more carryforward purposes. Such election must be filed by the earlier of (1) February 15 of the calendar year following the year in which the excess amount arises, or (2) the date of issue of bonds issued pursuant to the carryforward election.
6. Sec. 148(f)(3) and Treas. Reg. § 1.148-3(g)	An issuer of a tax-exempt municipal obligation must make any required rebate payment no later than 60 days after the computation date to which the payment relates. A rebate payment is paid when it is filed with the IRS at the place or places designated by the Commissioner. A payment must be accompanied by the form provided by the Commissioner for this purpose.
7. Treas. Reg. § 1.148-5(c)	An issuer of a tax-exempt municipal obligation must make a yield reduction payment on or before the date of required rebate installment payments as described in section 1.148-3(f), (g), and (h).
8. Sec. 148(f)(4)(C)(xvi) and Treas. Reg. § 1.148-7(k)(1)	As issuer of a tax-exempt municipal obligation that elects to pay certain penalties in lieu of rebate must make any required penalty payments not later than 90 days after the period to which the penalty relates.
9. Sec. 149(e)	An issuer of a tax-exempt municipal obligation must submit to the Secretary a statement providing certain information regarding the municipal obligation not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the municipal obligation is issued.

SECTION 17. SPECIAL RULES FOR SECTION 1031 LIKE-KIND EXCHANGE TRANSACTIONS

.01 Taxpayers are provided the relief described in this section if an IRS news release or other guidance provides relief for acts listed in this revenue procedure (unless the news release or other guidance specifies otherwise).

.02 (1) The last day of a 45-day identification period set forth in section 1.1031(k)-1(b)(2) of the Income Tax Regulations, the last day of a 180-day exchange period set forth in section 1.1031(k)-1(b)(2), and the last day of a period set forth in section 4.02(3) through (6) of Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, that fall on or after the date of a Presidentially declared disaster, are postponed by 120 days or to the last day of the general disaster extension period authorized by an IRS News Release or other guidance announcing tax relief for victims of the specific Presidentially declared disaster, whichever is later. However, in no event may a postponement period extend beyond: (a) the due date (including extensions) of the taxpayer's tax return for the year of the transfer (See Treas. Reg. § 1.1031(k)-1(b)(2)); or (b) one year (See IRC § 7508A(a)).

(2) A taxpayer who is a transferor qualifies for a postponement under this section only if—

(a) The relinquished property was transferred on or before the date of the Presidentially declared disaster, or in a transaction governed by Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, qualified *indicia* of ownership were transferred to the exchange accommodation titleholder on or before that date; and

(b) The taxpayer (transferor)—

(i) Is an "affected taxpayer" as defined in the IRS News Release or other guidance announcing tax relief for the victims of the specific Presidentially declared disaster; or

(ii) Has difficulty meeting the 45-day identification or 180-day exchange deadline set forth in section 1.1031(k)-1(b)(2), or a deadline set forth in section 4.02(3) through (6) of Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, due to the Presidentially declared disaster for the following or similar reasons:

(A) The relinquished property or the replacement property is located in a covered disaster area (as defined in section 301.7508A-1(d)(2)) as provided in the IRS News Release or other guidance (the covered disaster area);

(B) The principal place of business of any party to the transaction (for example, a qualified intermediary, exchange accommodation titleholder, transferee, settlement attorney, lender, financial institution, or a title insurance company) is located in the covered disaster area;

(C) Any party to the transaction (or an employee of such a party who is involved in the section 1031 transaction) is killed, injured, or missing as a result of the Presidentially declared disaster;

(D) A document prepared in connection with the exchange (for example, the agreement between the transferor and the qualified intermediary or the deed to the relinquished property or replacement property) or a relevant land record is destroyed, damaged, or lost as a result of the Presidentially declared disaster;

(E) A lender decides not to fund either permanently or temporarily a real estate closing due to the Presidentially declared disaster or refuses to fund a loan to the taxpayer because flood, disaster, or other hazard insurance is not available due to the Presidentially declared disaster; or

(F) A title insurance company is not able to provide the required title insurance policy necessary to settle or close a real estate transaction due to the Presidentially declared disaster.

.03 The postponement described in this section also applies to the last day of a 45-day identification period described in section 1.1031(k)-1(b)(2) and the last day of a 45-day identification period described in section 4.05(4) of Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, that falls prior to the date of a Presidentially declared disaster if an identified replacement property (in the case of an exchange described in section 1.1031(k)-1), or an identified relinquished property (in the case of an exchange described in Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51) is substantially damaged by the Presidentially declared disaster.

.04 If the taxpayer (transferor) qualifies for relief under this section for any reason other than section 17.02(2)(b)(i), then such taxpayer is not considered an affected taxpayer for purposes of any other act listed in this revenue procedure or for any acts listed in an IRS News Release or other published guidance related to the specific Presidentially declared disaster.

SECTION 18. INQUIRIES

If you wish to recommend that other acts qualify for postponement, please write to the Office of Associate Chief Counsel, Procedure and Administration CC:PA:B7, 1111 Constitution Avenue, NW, Washington, DC 20224. Please mark "7508A List" on the envelope. In the alternative, e-mail your comments to: *Notice.Comments@irscounsel.treas.gov*, and refer to Rev. Proc. 2005-27 in the Subject heading.

SECTION 19. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2005-27, 2005-1 C.B. 1050, is superseded.

SECTION 20. EFFECTIVE DATE

This revenue procedure is effective for acts that may be performed or disasters which occur on or after August 20, 2007.

SECTION 21. DRAFTING INFORMATION

The principal author of this revenue procedure is Melissa Quale in Branch 7, of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding section 1031 like-kind exchange postponements under section 17 of this revenue procedure, contact Peter J. Baumgarten or Michael F. Schmit of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622-4920 (not a toll-free call) or (202) 622-4960 (not a toll-free call), respectively. For further information regarding other sections of this revenue procedure, contact Ms. Quale at (202) 622-4570 (not a toll-free call).

REVENUE PROCEDURE 2004-13

ISSUE

In the situations described below, which plans meet the requirements of § 416(g)(4)(H) of the Internal Revenue Code for the 2004 plan year so that they are not subject to the top-heavy rules in § 416?

FACTS

Situation 1. A nongovernmental profit-sharing plan containing a cash or deferred arrangement ("CODA") described in § 401(k) provides for safe harbor matching contributions that are intended to satisfy the requirements of § 401(k)(12)(B) and otherwise satisfies the requirements of § 401(k)(12). The plan also permits the employer to make a nonelective contribution for any plan year at the employer's discretion. The nonelective contribution is subject to 5-year vesting described in § 411(a)(2)(A) and is allocated to participants' accounts in the same ratio that each participant's compensation bears to the compensation of all participants. The plan is a calendar-year plan and covers all employees of the employer (including highly compensated employees as defined in § 414(q)) who have 1 year of service and are age 21 or older. Other than elective contributions and the matching contributions, no other co ntributions are made to the plan for 2004 and there are no forfeitures.

Situation 2. The facts are the same as in Situation 1, except the employer makes a discretionary nonelective contribution to the plan for 2004.

Situation 3. The facts are the same as in Situation 1, except forfeitures occur in 2004 due to the severance from employment of a participant who was not fully vested in amounts attributable to discretionary nonelective contributions made in a prior year. Pursuant to the terms of the plan, forfeitures are allocated to participants' accounts for 2004 in the same manner as nonelective contributions.

Situation 4. The facts are the same as in Situation 1, except employees are permitted to make elective contributions immediately upon commencement of employment but are not eligible for matching contributions until they have completed 1 year of service with the employer.

LAW AND ANALYSIS

Under § 416, a plan that is a top-heavy plan (as defined in § 416(g)) for a plan year must satisfy the vesting requirements of § 416(b) and the minimum benefit requirements of § 416(c) for such plan year. Section 416 does not apply to any governmental plan.

Section 416(g)(4)(H) provides that the term "top-heavy plan" does not include a plan that consists solely of (1) a CODA that meets the requirements of § 401(k)(12) and (2) matching contributions that meet the requirements of § 401(m)(11). Section 416(g)(4)(H), which is effective for years beginning after December 31, 2001, was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16.

The determination of whether a plan is a top-heavy plan is made on a year-by-year basis. Thus, a plan that satisfies § 416(g)(4)(H) for one plan year may be subject to the top-heavy requirements the next plan year if it does not satisfy § 416(g)(4)(H) for the next plan year.

Section 401(k)(12) and § 401(m)(11) provide design-based safe harbor methods for satisfying the actual deferral percentage ("ADP") nondiscrimination test contained in § 401(k)(3)(A)(ii) and the actual contribution percentage ("ACP") nondiscrimination test contained in § 401(m)(2). Section 401(k)(12) provides that a CODA is treated as satisfying the ADP test if the CODA meets certain contribution and notice requirements. To satisfy the ADP test safe harbor contribution requirement, an employer must make either (1) a nonelective contribution equal to at least 3 percent of each eligible nonhighly compensated employee's compensation ("safe harbor nonelective contribution") or (2) a matching contribution that satisfies certain minimum amount and rate conditions ("safe harbor matching contribution"). Matching contributions do not satisfy § 401(k)(12) or § 401(m)(11) if the rate of matching contributions for a highly compensated employee at any rate of elective contributions is greater than that for a nonhighly compensated employee who is eligible to make elective contributions. Also, a plan does not meet the requirements of § 401(k)(12) if, under the terms of the plan, a nonhighly compensated employee is eligible to make elective contributions but is not eligible to receive either a safe harbor nonelective contribution or a safe harbor matching contribution. Safe harbor nonelective contributions and safe harbor matching contributions must be nonforfeitable when contributed to the plan and subject to withdrawal restrictions.

Section 401(m)(11) provides that a defined contribution plan is treated as satisfying the ACP test for matching contributions if the plan meets the requirements of § 401(k)(12) and in addition meets certain limitations on the amount and rate of matching contributions available under the plan.
In Situation 1, although the plan provides for discretionary nonelective contributions, none are made for 2004 and thus only contributions described in § 401(k)(12) or § 401(m)(11) are made to the plan for that year.

In Situation 2, the employer makes a discretionary nonelective contribution for 2004, a type of contribution that is not described in § 401(k)(12) or § 401(m)(11).

In Situation 3, the allocation of forfeitures to participants' accounts does not satisfy the requirements for safe harbor nonelective contributions under § 401(k)(12).

In Situation 4, under the plan, newly hired nonhighly compensated employees who make elective contributions will not be eligible to receive any matching contributions until they have completed 1 year of service. Since this will result in a greater rate of matching contributions for highly compensated employees than for nonhighly compensated employees, the matching contributions do not satisfy the requirements of § 401(k)(12) (or § 401(m)(11)). Further, since all eligible nonhighly compensated employees under the plan do not receive safe harbor nonelective contributions or safe harbor matching contributions, the matching contributions made under the plan do not satisfy the requirements of § 401(k)(12). However,

certain plans that provide for early participation may satisfy the requirements of § 401(k)(12) with respect to the portion of the plan that covers employees who have completed the minimum age and service requirements of § 410(a)(1), while satis fying the ADP test of § 401(k)(3)(A)(ii) for the eligible employees who have not completed the minimum age and service requirements. Unless a plan (within the meaning of § 414(l)) meets the requirements of § 416(g)(4)(H), no portion of the plan will satisfy § 416(g)(4)(H). (See Notice 2000-3, 2000-1 C.B. 413, Q&A-10.)

HOLDINGS

In Situation 1, the plan meets the requirements of § 416(g)(4)(H) and is therefore not subject to the top-heavy rules in § 416 for 2004 because no other contributions are made to the plans other than contributions described in § 401(k)(12) or § 401(m)(11). The plans in Situation 2, Situation 3 and Situation 4 do not meet the requirements of § 416(g)(4)(H) and are therefore subject to the top-heavy rules in § 416 for 2004.

DRAFTING INFORMATION

The principal author of this revenue ruling is Roger Kuehnle of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Kuehnle may be reached at 1-202-283-9888 (not a toll-free number).

REVENUE PROCEDURE 2002-71

Internal Revenue Procedure
2002-46 I.R.B. 850

SECTION 1. PURPOSE

.01 This revenue procedure provides an updated list of time-sensitive acts, the performance of which may be postponed under sections 7508 and 7508A of the Internal Revenue Code (Code). Section 7508 of the Code postpones specified acts for individuals serving in the Armed Forces of the United States or serving in support of such Armed Forces in a combat zone. Section 7508A of the Code permits a postponement of specified acts for taxpayers affected by a Presidentially declared disaster or a terroristic or military action. The list of acts in this revenue procedure supplements the list of postponed acts in section 7508(a)(1) of the Code and section 301.7508A–1(b) of the Regulations on Procedure and Administration.

.02 This revenue procedure does not, by itself, provide any postponements under sections 7508 or 7508A. In order for taxpayers to be entitled to a postponement of any act listed in this revenue procedure, the IRS generally will publish a Notice or issue other guidance (including an IRS News Release) providing relief with respect to a specific combat zone, Presidentially declared disaster, or a terroristic or military action.

.03 This revenue procedure will be updated as needed when the IRS determines that additional acts should be included in the list of postponed acts or that certain acts should be removed from the list. Also, taxpayers may recommend that additional acts be considered for postponement under sections 7508 and 7508A. See section 17 of this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 7508(a)(1) of the Internal Revenue Code permits a postponement of certain time-sensitive acts for individuals serving in the Armed Forces or in support of such Armed Forces in an area designated by the President as a combat zone under section 112. Among these acts are the filing of returns, the payment of tax, the filing of a Tax Court petition, and the filing of a refund claim. In the event of service in a combat zone, the acts specified in section 7508(a)(1) of the Code are *automatically postponed* . In addition, if the Service publishes a Notice or other guidance providing additional relief under section 7508, some or all of the acts listed in this revenue procedure may be postponed. Likewise, acts not listed in this revenue procedure may be included in published guidance.

.02 Section 7508A of the Code provides that certain acts performed by taxpayers and the government may be postponed if the taxpayer is affected by a Presidentially declared disaster or a terroristic or military action. A "Presidentially declared disaster" is defined in section 1033(h)(3) of the Code. A "terroristic or military action" is defined in section 692(c)(2) of the Code. Section 301.7508A– 1(d)(1) of the regulations defines seven types of affected taxpayers, including any individual whose principal residence (for purposes of section 1033(h)(4)) is located in a "covered disaster area" and any business entity or sole proprietor whose principal place of business is located in a "covered disaster area." Postponements under section 7508A are not available simply because a disaster or a terroristic or military action has occurred. Generally, the IRS will publish a Notice or issue other guidance (including an IRS News Release) authorizing the postponement. Such guidance will describe the *acts* postponed, the *duration* of the postponement, and the *location* of the covered disaster area. See, for example, Notice 2001–68, 2001–2 C.B. 504, *supplementing* Notice 2001–61, 2001–2 C.B. 305. When a Notice or other guidance for a particular disaster is published, or issued, the guidance generally will refer to this revenue procedure and may provide for a postponement of all the acts listed in the regulations and this revenue procedure. Alternatively, the guidance may provide that only certain acts listed in this revenue procedure are postponed based on the time when the disaster occurred, its severity, and other factors.

SECTION 3. SCOPE

This revenue procedure applies to individuals serving in the Armed Forces in a combat zone, or in support of such Armed Forces, to affected taxpayers within the meaning of section 301.7508A–1(d)(1) of the regulations, and to taxpayers whom the IRS determines are affected by a terroristic or military action.

SECTION 4. APPLICATION

.01 The tables below list sections of the Internal Revenue Code and Treasury Regulations requiring the timely performance of specified acts that may be postponed under sections 7508 and 7508A.

.02 In order to avoid unnecessary duplication, the following tables do not include acts specified in sections 7508 or 7508A or the regulations thereunder. Thus, for example, no mention is made in the following tables of the filing of tax returns or the payment of taxes (or an installment thereof) because these acts are already covered by sections 7508 and 7508A and the regulations thereunder. Also, the following tables do not refer to the making of accounting method elections or any other elections required to be made on tax returns or attachments thereto. Reference to these elections is not necessary because postponement of the filing of a tax return automatically postpones the making of any election required to be made on the return or an attachment thereto.

.03 The following tables refer only to postponement of acts performed by taxpayers. Additional guidance will be published in the Internal Revenue Bulletin if a decision is made that acts performed by the government may be postponed under section 7508 or section 7508A.

SECTION 5. ACCOUNTING METHODS AND PERIODS

	Statute or Regulation	Act Postponed
1.	Chapter 1, Subchapter E of the Code	Any act relating to the adoption, election, retention, or change of any accounting method or accounting Period, or to the use of an accounting method or accounting period, that is required to be performed on or before the due date of a tax return (including extensions). Examples of such acts include (a) the requirements in Rev. Proc. 2002–37, 2002–38, and 2002–39 that Form 1128, *Application to Adopt, Change, or Retain a Tax Year* , be filed with the Director, Internal Revenue Service Center, on or before the due date (or the due date including extensions) of the tax return for the short period required to effect the change in accounting period; and (b) the requirement in Rev. Proc. 2002–9, 2002–3 I.R.B. 327, section 6.02 (3) that a copy of Form 3115 must be filed with the national office no later than when the original Form 3115 is filed with the timely filed tax return for the year of the accounting method change.
2.	Treas. Reg. § 1.381(c)(4)–1(d)(2)	If the acquiring corporation is not permitted to use the method of accounting used by the acquiring corporation, the method of accounting used by the distributor/transferor corporation, or the principal method of accounting; or if the corporation wishes to use a new method of accounting, then the acquiring corporation must apply to the Commissioner to use another method. Treas. Reg. § 1.381(c)(4)–1(d)(2) requires applications to be filed not later than 90 days after the date of distribution or transfer. Rev. Proc. 83–77, 1983–2 C.B. 594, provides an automatic 90-day extension.
3.	Treas. Reg. § 1.381(c)(5)–1(d)(2)	If the acquiring corporation is not permitted to use the inventory method used by the acquiring corporation, the inventory method used by the distributor/transferor corporation, or the principal method of accounting, or wishes to use a new method of accounting, then the acquiring corporation must apply to the Commissioner to use another method. Treas. Reg. § 1.381(c)(5)- 1(d)(2) requires applications to be filed not later than 90 days after the date of distribution or transfer. Rev. Proc. 83-77 provides an automatic 90-day extension.
4.	Treas. Reg. § 1.442–1(b)(1)	In order to secure prior approval of an adoption, change or retention of a taxpayer's annual accounting period, the taxpayer generally must file an application on Form 1128, *Application to Adopt, Change, or Retain a Tax Year* , with the Commissioner within such time as is provided in administrative procedures published by the Commissioner from time to time. See, for example, Rev. Procs. 66–50, 1966–2 C.B. 1260, 2002–37, 2002–22 I.R.B. 1030, 2002–38, 2002–22 I.R.B. 1037, and 2002–39, 2002–22 I.R.B. 1046.
5.	Treas. Reg. § 1.444–3T(b)(1)	A section 444 election must be made by filing Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year* , with the Service Center. Generally, Form 8716 must be filed by the earlier of (a) the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or (b) the due date (without regard to extensions) of the income tax return resulting from the section 444 election.
6.	Treas. Reg. § 1.446–1(e)(2)(i)	Section 6 of Rev. Proc. 2002–9, 2002–3 I.R.B. 327, 341, allows a taxpayer to change a method of accounting within the terms of the revenue procedure by attaching the application form to the timely filed return for the year of change. Section 6.02(3)(b) grants an automatic extension of 6 months within which to file an amended return with the application for the change following a timely filed original return for the year of change.
7.	Treas. Reg. § 1.446–1(e)(3)(i)	To secure the Commissioner's consent to a change in method of accounting, the taxpayer must file an application on Form 3115, *Application for Change in Accounting Method* , with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting (*i.e.* , must be filed by the last day of such taxable year). This filing requirement is also in Rev. Proc. 97–27, 1997–1 C.B. 680. (But see Rev. Proc. 2002–9 for automatic changes in method of accounting that can be made with the return.)
8.	Treas. Reg. § 1.461–1(c)(3)(ii)	A taxpayer may elect, with the consent of the Commissioner, to accrue real property taxes ratably in accordance with section 461(c). A written request for permission to make such an election must be submitted within 90 days after the beginning of the taxable year to which the election is first applicable. Rev. Proc. 83–77 provides an automatic 90-day extension.
9.	Treas. Reg. § 1.7519–2T(a)(2), (3) and (4)	A partnership or S corporation must file the Form 8752, *Required Payment or Refund Under Section 7519* , if the taxpayer has made an election under section 444 to use a taxable year other than its required taxable year and the election is still in effect. The Form 8752 must be filed and any required payment must be made by the date stated in the instructions to Form 8752.
10.	Rev. Proc. 92–29, section 6.02	A developer of real estate requesting the Commissioner's consent to use the alternative cost method must file a private letter ruling request within 30 days after the close of the taxable year in which the first benefitted property in the project is sold. The request must include a consent extending the period of limitation on the assessment of income tax with respect to the use of the alternative cost method.

SECTION 6. BUSINESS AND INDIVIDUAL TAX ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 1.71–1T(b), Q&A–7	A payer spouse may send cash to a third party on behalf of a spouse that qualifies for alimony or separate maintenance payments if the payments are made to the third party at the written request or consent of the payee spouse. The request or consent must state that the parties intend the payment to be treated as an alimony payment to the payee spouse subject to the rules of section 71. The payer spouse must receive the request or consent prior to the date of filing of the payer spouse's first return of tax for the taxable year in which the payment was made.
2.	Treas. Reg. § 1.77–1	A taxpayer who receives a loan from the Commodity Credit Corporation may elect to include the amount of the loan in his gross income for the taxable year in which the loan is received. The taxpayer in subsequent taxable years must include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Treas. Reg. § 1.77–1 requires such requests to be filed within 90 days after the beginning of the taxable year of change. Rev. Proc. 83–77 provides an automatic 90-day extension.

3.	Treas. Reg. § 1.110–1(b)(4)(ii)(A)	The lessee must expend its construction allowance on the qualified long-term real property within eight and one-half months after the close of the taxable year in which the construction allowance was received.
4.	Sec. 118(c)(2)	A contribution in aid of construction received by a regulated public utility that provides water or sewerage disposal services must be expended by the utility on qualifying property before the end of the second taxable year after the year in which it was received by the utility.
5.	Treas. Reg. § 1.170A–5(a)(2)	A contribution of an undivided present interest in tangible personal property shall be treated as made upon receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred for more than one year.
6.	Sec. 172(b)(1)(H)	Certain taxpayers desiring to take advantage of the new 5-year carryback period, and/or desiring to apply for a tentative carryback adjustment, must act on or before a specified date. (See Rev. Proc. 2002–40, 2002–23 I.R.B. 1096).
7.	Sec. 468A(g)	A taxpayer that makes payments to a nuclear decommissioning fund with respect to a taxable year must make the payments within 2½ months after the close of such taxable year (the deemed payment date).
8.	Sec. 530(h)	A trustee of a Coverdell education savings account must provide certain information concerning the account to the beneficiary by January 31 following the calendar year to which the information relates. In addition, Form 5498 must be filed with the IRS by May 31 following the calendar year to which the information relates.
9.	Sec. 563(a)	In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15 th day of the third month following the close of such taxable year shall be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the 3½-month period within which the dividend is paid is the period extended.
10.	Sec. 563(b)	In the determination of the dividends paid deduction for purposes of the personal holding company tax imposed by section 541, a dividend paid after the close of any taxable year and on or before the 15 th day of the third month following the close of such taxable year shall, to the extent the taxpayer elects on its return for the taxable year, be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the 3½-month period within which the dividend is paid is the period extended.
11.	Sec. 563(c)	In the determination of the dividends paid deduction for purposes of part III, a dividend paid after the close of any taxable year and on or before the 15 th day of the third month following the close of such taxable year shall, to the extent the company designates such dividend as being taken into account, be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the 3½-month period within which the dividend is paid is the period extended.
12.	Sec. 563(d)	For the purpose of applying section 562(a), with respect to distributions under subsection (a), (b), or (c) of section 562, a distribution made after the close of the taxable year and on or before the 15 th day of the third month following the close of the taxable year shall be considered as made on the last day of such taxable year. The close of the taxable year is not affected by this revenue procedure; the 3½-month period within which the dividend is paid is the period extended.
13.	Treas. Reg. § 1.468A–3(h)(1)(v)	A taxpayer must file a request for a schedule of ruling amounts for a nuclear decommissioning fund by the deemed payment date (2½-months after the close of the taxable year for which the schedule of ruling amounts is sought).
14.	Treas. Reg. § 1.468A–3(h)(1)(vii)	A taxpayer has 30 days to provide additional requested information with respect to a request for a schedule of ruling amounts. If the information is not provided within the 30 days, the request will not be considered filed until the date the information is provided.
15.	Sec. 529 (c)(3)(C)(i)	A rollover contribution to another qualified tuition program must be made no later than the 60th day after the date of a distribution from a qualified tuition program.
16.	Sec. 530(d)(4)(C)(i)	Excess contributions to a Coverdell education savings account must be distributed before a specified time in the taxable year following the taxable year in which the contribution is made.
17.	Sec. 530(d)(5)	A rollover contribution to another Coverdell education savings account must be made no later than the 60th day after the date of a payment or distribution from a Coverdell education savings account.
18.	Sec. 1031(a)	Any property received by the taxpayer shall be treated as property which is not like-kind property if — (A) such 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) such 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.
19.	Treas. Reg. § 1.1033(c)(3)	Certain elections respecting the non recognition of gain on the involuntary conversion of property (Treas. Reg. §§ 1.1033(c)(1) and (2)) are required to be made within the time periods specified in Treas. Reg. § 1.1033(c)(3).
20.	Sec. 1043(a)	If an eligible person (as defined under section 1043(b)) sells any property pursuant to a certificate of divestiture, then at the election of the taxpayer, gain from such sale shall be recognized only to the extent that the amount realized on such sale exceeds the cost of any permitted property purchased by the taxpayer during the 60-day period beginning on the date of such sale.
21.	Sec. 1045(a)	A taxpayer other than a corporation may elect to roll over gain from the sale of qualified small business stock held for more than six months if other qualified small business stock is purchased by the taxpayer during the 60-day period beginning on the date of sale.
22.	Sec. 1382(d)	An organization, to which section 1382(d) applies, is required to pay a patronage dividend within 8½ months after the close of the year.
23.	Sec. 1388(j)(3)(A)	Any cooperative organization that exercises its option to net patronage gains and losses, is required to give notice to its patrons of the netting by the 15 th day of the 9 th month following the close of the taxable year.
24.	Treas. Reg. § 301.7701–3(c)	The effective date of an entity classification election (Form 8832) cannot be more than 75 days prior to the date on which the election is filed.
25.	Treas. Reg.	An automatic extension of 12 months from the due date for making a regulatory election is granted to make certain

	§ 301.9100–2(a)(1)	elections, including the election to use other than the required taxable year under section 444, and the election to use LIFO under section 472.
26.	Treas. Reg. §§ 301.9100–2(b)–(d)	An automatic extension of 6 months from the due date of a return, excluding extensions, is granted to make the regulatory or statutory elections whose due dates are the due date of the return or the due date of the return including extensions (for example, a taxpayer has an automatic 6 month extension to file an application to change a method of accounting under Rev. Proc. 2002–9), provided the taxpayer (a) timely filed its return for the year of election, (b) within that 6-month extension period, takes the required corrective action to file the election in accordance with the statute, regulations, revenue procedure, revenue ruling, notice or announcement permitting the election, and (c) writes at the top of the return, statement of election or other form "FILED PURSUANT TO § 301.9100–2."
27.	Notice 2002–25	Notice 2002–25, 2002–15 I.R.B. 743, relaxes the contemporaneous written acknowledgment requirement for charitable contributions of $250 or more made after September 10, 2001, and before January 1, 2002, if taxpayers obtain the written acknowledgment or have evidence of a good-faith attempt to obtain it by October 15, 2002.

SECTION 7. CORPORATE ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 302(e)(1)	A corporation must complete a distribution in pursuance of a plan of partial liquidation of a corporation within the specified period.
2.	Sec. 303 and Treas. Reg. § 1.303–2	A corporation must complete the distribution of property to a shareholder in redemption of all or part of the stock of the corporation which (for Federal estate tax purposes) is included in determining the estate of a decedent. Section 303 and Treas. Reg. § 1.303–2 require, among other things, that the distribution occur within the specified period.
3.	Sec. 304(b)(3)(C)	If certain requirements are met, section 304(a) does not apply to a transaction involving the formation of a bank holding company. One requirement is that within a specified period (generally 2 years) after control of a bank is acquired, stock constituting control of the bank is transferred to a bank holding company in connection with the bank holding company's formation.
4.	Sec. 332(b) and Treas. Reg. §§ 1.332–3 and 1.332–4	A corporation must completely liquidate a corporate subsidiary within the specified period.
5.	Sec. 338(d)(3) and (h), and Treas. Reg. § 1.338–2	An acquiring corporation must complete a "qualified stock purchase" of a target corporation's stock within the specified acquisition period.
6.	Sec. 338(g) and Treas. Reg. § 1.338–2	An acquiring corporation may elect to treat certain stock purchases as asset acquisitions. The election must be made within the specified period.
7.	Sec. 338(h)(10) and Treas. Reg. § 1.338(h)(10)–1(c)	An acquiring corporation and selling group of corporations may elect to treat certain stock purchases as asset purchases, and to avoid gain or loss upon the stock sale. The election must be made within the specified period.
8.	Sec. 341 and Treas. Reg. § 1.341–7	A shareholder of a collapsible corporation must sell its stock in the corporation within the specified period.
9.	Treas. Reg. § 1.381(c)(17)–1(c)	An acquiring corporation files a Form 976, *Claim for Deficiency Dividends Deduction by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust* , within 120 days after the date of the determination under section 547(c) to claim a deduction of a deficiency dividend.
10.	Treas. Reg. § 1.441–3(b)	A personal service corporation may obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period by filing Form 1128, *Application to Adopt, Change or Retain a Tax Year,* within such time as is provided in the administrative procedures published by the Commissioner. *See* Rev. Procs. 2002–38 and 2002–39.
11.	Sec. 562(b)(1)(B)	In the case of a complete liquidation (except in the case of a complete liquidation of a personal holding company or foreign personal holding company) occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to such plan shall, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend for purposes of computing the dividends paid deduction.
12.	Sec. 562(b)(2)	In the case of a complete liquidation of a personal holding company occurring within 24 months after the adoption of a plan of liquidation, the amount of any distribution within such period pursuant to such plan shall be treated as a dividend for purposes of computing the dividends paid deduction to the extent that such is distributed to corporate distributees and represents such corporate distributees' allocable share of the undistributed personal holding company income for the taxable year of such distribution.
13.	Sec. 1502 and Treas. Reg. § 1.1502–75(c)(1)(i)	A common parent must apply for permission to discontinue filing consolidated returns within a specified period after the date of enactment of a law affecting the computation of tax liability.
14.	Sec. 6425 and Treas. Reg. § 1.6425–1	Corporations applying for an adjustment of an overpayment of estimated income tax must file Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax* , on or before the 15 th day of the third month after the taxable year, or before the date the corporation first files its income tax return for such year, whichever is earlier.

SECTION 8. EMPLOYEE BENEFIT ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 72(p)(2)(B) and (C), and Treas. Reg. § 1.72(p)–1, Q&A–10	A loan from a qualified employer plan to a participant in, or a beneficiary of, such plan must be repaid according to certain time schedules specified in section 72(p)(2)(B) and (C) (including, if applicable, any grace period granted pursuant to Treas. Reg. § 1.72(p)–1, Q&A–10).
2.	Sec. 72(t)(2)(A)(iv)	Under section 72(t)(2)(A)(iv), to avoid the imposition of a 10-percent additional tax on a distribution from a qualified retirement plan, the distribution must be part of a series of substantially equal periodic payments, made at least annually.
3.	Sec. 72(t)(2)(F)	To avoid the imposition of a 10-percent additional tax on a distribution from an individual retirement arrangement (IRA) for a first-time home purchase, such distribution must be used within 120 days of the distribution to pay qualified acquisition costs or rolled into an IRA.
4.	Sec. 83(b) and Treas. Reg. § 1.83–2(b)	Any person who performs services in connection with which property is transferred to any person may elect not later than 30 days after the date of the transfer of the property to include in his gross income, for the taxable year in which such property is transferred, the excess of the fair market value of the property over the amount (if any) paid for the property.
5.	Proposed Treas. Reg. § 1.125–1, Q&A–15	Cafeteria plan participants will avoid constructive receipt of the taxable amounts if they elect the benefits they will receive before the beginning of the period during which the benefits will be provided.
6.	Proposed Treas. Reg. § 1.125–1, Q&A–14 and Proposed Treas. Reg. § 1.125–2, Q&A–7	Cafeteria plan participants will not be in constructive receipt if, at the end of the plan year, they forfeit amounts elected but not used during the plan year.
7.	Proposed Treas. Reg. § 1.125–2, Q&A–5	Cafeteria plan participants may receive in cash the value of unused vacation days on or before the earlier of the last day of the cafeteria plan year or the last day of the employee's taxable year to which the unused days relate.
8.	Treas. Reg. § 1.162–27(e)(2)	A performance goal is considered preestablished if it is established in writing by the corporation's compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates if the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. In no event, however, will the performance goal be considered pre-established if it is established after 25 percent of the period of service has elapsed.
9.	Sec. 220(f)(5)	A rollover contribution to an Archer MSA must be made no later than the 60th day after the day on which the holder receives a payment or distribution from an Archer MSA.
10.	Sec. 220(h)	A trustee or custodian of an MSA (Archer MSA or Medicare+Choice MSA) must provide certain information concerning the MSA to the account holder by January 31 following the calendar year to which the information relates. In addition, MSA contribution information must be furnished to the account holder, and Form 5498, IRA Contribution Information, filed with the IRS, by May 31 following the calendar year to which the information relates.
11.	Secs. 401(a)(9), 403(a)(1), 403(b)(10), 408(a)(6), 408(b)(3) and 457(d)(2)	The first required minimum distribution from plans subject to the rules in section 401(a)(9) must be made no later than the required beginning date. Subsequent required minimum distributions must be made by the end of each distribution calendar year.
12.	Sec. 401(a)(28)(B)(i)	A qualified participant in an ESOP (as defined in section 401(a)(28)(B)(iii)) may elect within 90 days after the close of each plan year in the qualified election period (as defined in section 401(a)(28)(B)(iv)) to direct the plan as to the investment of at least 25 percent of the participant's account in the plan (50 percent in the case of the last election).
13.	Sec. 401(a)(28)(B)(ii)	A plan must distribute the portion of the participant's account covered by an election under section 401(a)(28)(B)(i) within 90 days after the period during which an election can be made; or the plan must offer at least 3 investment options (not inconsistent with regulations prescribed by the Secretary) to each participant making the election under section 401(a)(28)(B)(i) and within 90 days after the period during which the election may be made, the plan must invest the portion of the participant's account in accordance with the participant's election.
14.	Sec. 401(a)(30) and Treas. Reg. § 1.401(a)–30 and § 1.402(g)–1	Excess deferrals for a calendar year, plus income attributable to the excess, must be distributed no later than the first April 15 following the calendar year.
15.	Sec. 401(b) and Treas. Reg. § 1.401(b)–1	A retirement plan that fails to satisfy the requirements of section 401(a) or section 403(a) on any day because of a disqualifying provision will be treated as satisfying such requirements on such day if, prior to the expiration of the applicable remedial amendment period, all plan provisions necessary to satisfy the requirements of section 401(a) or 403(a) are in effect and have been made effective for the whole of such period.
16.	Sec. 401(k)(8)	A cash or deferred arrangement must distribute excess contributions for a plan year, plus income attributable to the excess, pursuant to the terms of the arrangement no later than the close of the following plan year.
17.	Sec. 401(m)(6)	A plan subject to section 401(m) must distribute excess aggregate contributions for a plan year, plus income attributable to the excess, pursuant to the terms of the plan no later than the close of the following plan year.
18.	Sec. 402(g)(2)(A) and Treas. Reg. § 1.402(g)–1	An individual with excess deferrals for a taxable year must notify a plan, not later than a specified date following the taxable year, that excess deferrals have been contributed to that plan for the taxable year. A distribution of excess deferrals identified by the individual, plus income attributable to the excess, must be accomplished no later than the first April 15 following the taxable year of the excess.
19.	Sec. 404(k)(2)(A)(ii)	An ESOP receiving dividends on stock of the C corporation maintaining the plan must distribute the dividend in cash to participants or beneficiaries not later than 90 days after the close of the plan year in which the dividend was paid.

20.	Secs. 408(i) and 6047(c)	A trustee or issuer of an individual retirement arrangement (IRA) must provide certain information concerning the IRA to the IRA owner by January 31 following the calendar year to which the information relates. In addition, IRA contribution information must be furnished to the owner, and Form 5498, *Individual Retirement Arrangement Information* , filed with the IRS, by May 31 following the calendar year to which the information relates.
21.	Sec. 409(h)(4)	An employer required to repurchase employer securities under section 409(h)(1)(B) must provide a put option for a period of at least 60 days following the date of distribution of employer securities to a participant, and if the put option is not exercised, for an additional 60-day period in the following plan year. A participant who receives a distribution of employer securities under section 409(h)(1)(B) must exercise the put option provided by that section within a period of at least 60 days following the date of distribution, or if the put option is not exercised within that period, for an additional 60-day period in the following plan year.
22.	Sec. 409(h)(5)	An employer required to repurchase employer securities distributed as part of a total distribution must pay for the securities in substantially equal periodic payments (at least annually) over a period beginning not later than 30 days after the exercise of the put option and not exceeding 5 years.
23.	Sec. 409(h)(6)	An employer required to repurchase employer securities distributed as part of an installment distribution must pay for the securities not later than 30 days after the exercise of the put option under section 409(h)(4).
24.	Sec. 409(o)	An ESOP must commence the distribution of a participant's account balance, if the participant elects, not later than 1 year after the close of the plan year — i) in which the participant separates from service by reason of attaining normal retirement age under the plan, death or disability; or ii) which is the 5 th plan year following the plan year in which the participant otherwise separates from service (except if the participant is reemployed before distribution is required to begin).
25.	Sec. 457(e)(16)(B)	An eligible rollover distribution from a section 457 eligible governmental plan may be rolled over to an eligible retirement plan no later than the 60 th day following the day the distributee received the distributed property.
26.	Sec. 1042(a)(2)	A taxpayer must purchase qualified replacement property (defined in section 1042(c)(4)) within the replacement period, defined in section 1042(c)(3) as the period which begins 3 months before the date of the sale of qualified securities to an ESOP and ends 12 months after the date of such sale.
27.	Treas. Reg. § 1.1042–1T, Q&A–3	A taxpayer must notarize any statement of purchase with respect to qualified replacement property required under Treas. Reg. § 1.1042–1T, Q&A–3 no later than 30 days after a purchase of qualified replacement property.
28.	Sec. 4972(c)(3)	Nondeductible plan contributions must be distributed prior to a certain date to avoid a 10 percent tax.
29.	Sec. 4979 and Treas. Reg. § 54.4979–1	A 10 percent tax on the amount of excess contributions and excess aggregate contributions under a plan for a plan year will be imposed unless the excess, plus income attributable to the excess is distributed (or, if forfeitable, forfeited) no later than 2½-months after the close of the plan year. In the case of an employer maintaining a SARSEP, employees must be notified of the excess by the employer within the 2½-month period to avoid the tax.
30.	Secs. 6033, 6039D, 6047, 6057, 6058, and 6059	Form 5500 and Form 5500–EZ, which are used to report annual information concerning employee benefit plans and fringe benefit plans, must be filed by a specified time. *General Advice* Affected filers are advised to follow the instructions accompanying the Form 5500 series (or other guidance published on the postponement) regarding how to file the forms when postponements are granted pursuant to section 7508 or section 7508A. *Combat Zone Postponements under Section 7508* In the case of taxpayers who are individuals, the IRS may permit a postponement of the filing of the Form 5500 or Form 5500–EZ under section 7508. Whatever postponement of the Form 5500 series filing due date is permitted by the IRS under section 7508 will also be permitted by the Department of Labor and the Pension Benefit Guaranty Corporation (PBGC) for similarly situated individuals who are plan administrators. *Postponements for Presidentially Declared Disasters and Terroristic or Military Actions under Section 7508A* In the case of "affected taxpayers," as defined in Treas. Reg. § 301. 7508A–1(d), the IRS may permit a postponement of the filing of the Form 5500 or Form 5500–EZ. Taxpayers who are unable to obtain on a timely basis information necessary for completing the forms from a bank, insurance company, or any other service provider because such service providers' operations are located in a covered disaster area will be treated as "affected taxpayers." Whatever postponement of the Form 5500 series filing due date is permitted by the IRS under section 7508A will also be permitted by the Department of Labor and PBGC for similarly situated plan administrators and direct filing entities.
31.	Rev. Proc. 2002–47, Sections 9.02 (1) and (2)	The correction period for self-correction of operational failures is the last day of the second plan year following the plan year for which the failure occurred. The correction period for self-correction of operational failures for transferred assets does not end until the last day of the first plan year that begins after the corporate merger, acquisition, or other similar employer transaction.
32.	Rev. Proc. 2002–47, Section 12.08	If the submission involves a plan with transferred assets and no new incidents of the failures in the submission occurred after the end of the second plan year that begins after the corporate merger, acquisition, or other similar employer transaction, the plan sponsor may calculate the amount of plan assets and number of plan participants based on the Form 5500 information that would have been filed by the plan sponsor for the plan year that includes the employer transaction if the transferred assets were maintained as a separate plan.
33.	Rev. Proc. 2002–47, Section 14.03	If an examination involves a plan with transferred assets and the IRS determines that no new incidents of the failures that relate to the transferred assets occurred after the end of the second plan year that begins after the corporate merger,

		acquisition, or other similar employer transaction, the sanction under Audit CAP will not exceed the sanction that would apply if the transferred assets were maintained as a separate plan.

SECTION 9. ESTATE, GIFT AND TRUST ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 643(g)	The trustee may elect to treat certain payments of estimated tax as paid by the beneficiary. The election shall be made on or before the 65 th day after the close of the taxable year of the trust.
2.	Sec. 2011(c)	The executor of a decedent's estate must file a claim for a credit for state estate, inheritance, legacy or succession taxes by filing a claim within 4 years of filing Form 706, *United States Estate (and Generation Skipping Transfer) Tax Return.*
3.	Sec. 2014(e)	The executor of a decedent's estate must file a claim for foreign death taxes within 4 years of filing Form 706, *United States Estate (and Generation Skipping Transfer) Tax Return.*
4.	Sec. 2016 and Treas. Reg. § 20.2016–1	If an executor of a decedent's estate (or any other person) receives a refund of any state or foreign death taxes claimed as a credit on Form 706, the IRS must be notified within 30 days of receipt.
5.	Sec. 2031(c)	If an executor of a decedent's estate elects on Form 706 to exclude a portion of the value of land that is subject to a qualified conservation easement, agreements relating to development rights must be implemented within 2 years after the date of the decedent's death.
6.	Sec. 2032(d)	The executor of a decedent's estate may elect an alternate valuation on a late filed Form 706 if the Form 706 is not filed later than 1 year after the due date.
7.	Sec. 2032A(c)(7)	A qualified heir, with respect to specially valued property, is provided a two- year grace period immediately following the date of the decedent's death in which the failure by the qualified heir to begin using the property in a qualified use will not be considered a cessation of qualified use and therefore will not trigger additional estate tax.
8.	Sec. 2032A(d)(3)	The executor of a decedent's estate has 90 days after notification of incomplete information/signatures to provide the information/signatures to the IRS regarding an election on Form 706 with respect to specially valued property.
9.	Sec. 2046	A taxpayer may make a qualified disclaimer no later than 9 months after the date on which the transfer creating the interest is made, or the date the person attains age 21.
10.	Sec. 2053(d) and Treas. Reg. §§ 20.2053–9(c) and 10(c)	If the executor of a decedent's estate elects to take a deduction for state and foreign death tax imposed upon a transfer for charitable or other uses, the executor must file a written notification to that effect with the IRS before expiration of the period of limitations on assessments (generally 3 years).
11.	Sec. 2055(e)(3)	A party in interest must commence a judicial proceeding to change an interest into a qualified interest no later than the 90th day after the estate tax return (Form 706) is required to be filed or, if no return is required, the last date for filing the income tax return for the first taxable year of the trust.
12.	Sec. 2056(d)	A qualified domestic trust (QDOT) election must be made on Form 706, Schedule M, and the property must be transferred to the trust before the date on which the return is made. Any reformation to determine if a trust is a QDOT requires that the judicial proceeding be commenced on or before the due date for filing the return.
13.	Sec. 2056A(b)(2)	The trustee of a QDOT must file a claim for refund of excess tax no later than 1 year after the date of final determination of the decedent's estate tax liability.
14.	Sec. 2057(i)(3)(G)	A qualified heir, with respect to qualified family owned business, has a two- year grace period immediately following the date of the decedent's death in which the failure by the qualified heir to begin using the property in a qualified use will not be considered a cessation of qualified use and therefore will not trigger additional estate tax.
15.	Sec. 2057(i)(3)(H)	The executor of a decedent's estate has 90 days after notification of incomplete information/signatures to provide the information/signatures to the IRS regarding an election on Form 706 with respect to specially valued property.
16.	Sec. 2516	The IRS will treat certain transfers as made for full and adequate consideration in money or money's worth where husband and wife enter into a written agreement relative to their marital and property rights and divorce actually occurs within the 3-year period beginning on the date 1 year before such agreement is entered into.
17.	Sec. 2518(b)	A taxpayer may make a qualified disclaimer no later than 9 months after the date on which the transfer creating the interest is made, or the date the person attains age 21.

SECTION 10. EXEMPT ORGANIZATION ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 505(c)(1)	An organization must give notice by filing Form 1024, *Application for Recognition of Exemption Under Section 501(a)* , to be recognized as an organization exempt under section 501(c)(9) or section 501(c)(17). Generally, if the exemption is to apply for any period before the giving of the notice, Treas. Reg. § 505(c)–1T, Q&A–6 of the regulations requires that Form 1024 be filed within 15 months from the end of the month in which the organization was organized.
2.	Sec. 508 and Treas. Reg. § 1.508–1	A purported section 501(c)(3) organization must generally file Form 1023, *Application for Recognition of Exemption* , to qualify for exemption. Generally, if the exemption is to apply for any period before the giving of the notice, the Form 1023 must be filed within 15 months from the end of the month in which the organization was organized.
3.	Sec. 6072(e) and Treas. Reg. § 1.6033–2(e)	Annual returns of organizations exempt under section 501(a) must be filed on or before the 15 th day of the 5 th month following the close of the taxable year.

SECTION 11. EXCISE TAX ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 48.4101–1(h)(v)	A registrant must notify the IRS of any change in the information a registrant has submitted within 10 days.
2.	Sec. 4221(b) and Treas. Reg. § 48.4221–2(c)	A manufacturer is allowed to make a tax-free sale of articles for resale to a second purchaser for use in further manufacture. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.
3.	Sec. 4221(b) and Treas. Reg. § 48.4221–3(c)	A manufacturer is allowed to make a tax-free sale of articles for export. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.
4.	Sec. 4221(e)(2)(A) and Treas. Reg. § 48.4221–7(c)	A manufacturer is allowed to make a tax-free sale of tires for use by the purchaser in connection with the sale of another article manufactured or produced by the purchaser. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.

SECTION 12. INTERNATIONAL ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 482 and Treas. Reg. § 1.482–1(g)(4)(ii)(C)	A claim for a setoff of a section 482 allocation by the IRS must be filed within 30 days of either the date of the IRS's letter transmitting an examination report with notice of the proposed adjustment or the date of a notice of deficiency.

	Statute or Regulation	Act Postponed
2.	Sec. 482 and Treas. Reg. § 1.482–1(j)(2)	A claim for retroactive application of the final section 482 regulations, otherwise effective only for taxable years beginning after October 6, 1994, must be filed prior to the expiration of the statute of limitations for the year for which retroactive application is sought.
3.	Sec. 482 and Treas. Reg. § 1.482–7(j)(2)	A participant in a cost-sharing arrangement must provide documentation regarding the arrangement, as well as documentation specified in Treas. Reg. §§ 1.482–7(b)(4) and 1.482–7(c)(1), within 30 days of a request by the IRS.
4.	Treas. Reg. § 1.882–5(d)(2)(ii)(A)(2)	Liabilities of a foreign corporation that is not a bank must be entered on a set of books at a time reasonably contemporaneous with the time the liabilities are incurred.
5.	Treas. Reg. § 1.882–5(d)(2)(iii)(A)(1)	Liabilities of foreign corporations that are engaged in a banking business must be entered on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred.
6.	Treas. Reg. § 1.884–2T(b)(3)(i)	Requirement that marketable securities be identified on the books of a U.S. trade or business within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets. This requirement applies when a taxpayer has elected to be treated as remaining engaged in a U.S. trade or business for branch profits tax purposes.
7.	Treas. Reg. § 1.884–4(b)(3)(ii)(B)	Requirement that a foreign corporation which identifies liabilities as giving rise to U.S. branch interest, send a statement to the recipients of such interest within two months of the end of the calendar year in which the interest was paid, stating that such interest was U.S. source income (if the corporation did not make a return pursuant to section 6049 with respect to the interest payment).
8.	Sec. 922(a)(1)(E) and Treas. Reg. § 1.922–1(j) (Q&A–19)	The FSC must appoint a new non-U.S. resident director within 30 days of the date of death, resignation, or removal of the former director, in the event that the sole non-U.S. resident director of a FSC dies, resigns, or is removed.
9.	Sec. 924(b)(2)(B) and Treas. Reg. § 1.924(a)–1T(j)(2)(i)	A taxpayer must execute an agreement regarding unequal apportionment at a time when at least 12 months remain in the period of limitations (including extensions) for assessment of tax with respect to each shareholder of the small FSC in order to apportion unequally among shareholders of a small FSC the $5 million foreign trading gross receipts used to determine exempt foreign trade income.
10.	Sec. 924(c)(2) and Treas. Reg. § 1.924(c)–1(c)(4)	The FSC must open a new qualifying foreign bank account within 30 days of the date of termination of the original bank account, if a FSC's qualifying foreign bank account terminates during the taxable year due to circumstances beyond the control of the FSC.
11.	Sec. 924(c)(3) and Treas. Reg. § 1.924(c)–1(d)(1)	The FSC must transfer funds from its foreign bank account to its U.S. bank account, equal to the dividends, salaries or fees disbursed, and such transfer must take place within 12 months of the date of the original disbursement from the U.S. bank account, if dividends, salaries, or fees are disbursed from a FSC's U.S. bank account.
12.	Sec. 924(c)(3) and Treas. Reg. § 1.924(c)–1(d)(2)	The FSC must reimburse from its own bank account any dividends or other expenses that are paid by a related person, on or before the due date (including extensions) of the FSC's tax return for the taxable year to which the reimbursement relates.
13.	Sec. 924(c)(3) and Treas. Reg. § 1.924(c)–1(d)(3)	If the Commissioner determines that the taxpayer acted in good faith, the taxpayer may comply with the reimbursement requirement by reimbursing the funds within 90 days of the date of the Commissioner's determination, notwithstanding a taxpayer's failure to meet the return-filing-date reimbursement deadline in Treas. Reg. § 1.924(c)–1(d)(2).

	Statute or Regulation	Act Postponed
14.	Sec. 924(e)(4) and Treas. Reg. § 1.924(e)–1(d)(2)(iii)	If a payment with respect to a transaction is made directly to the FSC or the related supplier in the United States, the funds must be transferred to and received by the FSC bank account outside the United States no later than 35 days after the receipt of good funds (*i.e.* , date of check clearance) on the transaction.

15.	Temp. Treas. Reg. § 1.925(a)–1T(e)(4)	A FSC and its related supplier may redetermine a transfer pricing method, the amount of foreign trading gross receipts, and costs and expenses, provided such redetermination occurs before the expiration of the statute of limitations for claims for refund for both the FSC and related supplier, and provided such redetermination shall affect both the FSC and the related supplier. See Treas. Reg. § 1.925(a)–1(c)(8)(i) for time limitations with respect to FSC administrative pricing grouping redeterminations and for a cross-reference to Temp. Treas. Reg. § 1.925(a)–1T(e)(4).
16.	Sec. 927(f)(3)(A) and Treas. Reg. § 1.927(f)–1(b) (Q&A–12)	A corporation may terminate its election to be treated as a FSC or a small FSC by revoking the election during the first 90 days of the FSC taxable year (other than the first year in which the election is effective) in which the election was to take effect.
17.	Sec. 927 and Temp. Treas. Reg. § 1.927(a)–1T(d)(2)(i)(B)	A taxpayer may satisfy the destination test with respect to property sold or leased by a seller or lessor if such property is delivered by the seller or lessor (or an agent of the seller or lessor) within the United States to a purchaser or lessee, if the property is ultimately delivered outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within one year after the sale or lease.
18.	Sec. 927 and Temp. Treas. Reg. § 1.927(b)–1T(e)(2)(i)	A taxpayer that claims FSC commission deductions must designate the sales, leases, or rentals subject to the FSC commission agreement no later than the due date (as extended) of the tax return of the FSC for the taxable year in which the transaction(s) occurred.
19.	Sec. 927 and Treas. Reg. § 1.927(f)–1(a) (Q&A–4)	A transferee or other recipient of shares in the corporation (other than a shareholder that previously consented to the election) must consent to be bound by the prior election within 90 days of the first day of the FSC's taxable year to preserve the status of a corporation that previously qualified as a FSC or as a small FSC.
20.	Sec. 936 and Treas. Reg. § 1.936–10(c)	If a "qualified investment" in a Caribbean Basin country ceases to meet the qualification requirements, the taxpayer may correct any disqualifying events within a reasonable period of time, which is defined as not more than 60 days from the date that such events came to the attention of the taxpayer (or should have come to its attention by the exercise of reasonable diligence).
21.	Sec. 936 and Treas. Reg. § 1.936–11	A taxpayer that elects retroactive application of the temporary regulation regarding separate lines of business for taxable years beginning after December 31, 1995, must elect to do so prior to the expiration of the statute of limitations for the year in question.
22.	Treas. Reg. §§ 1.964–1(c)(3)(ii) and –1T(g)(2).	An election of, or an adoption of or change in a method of accounting of a CFC (controlled foreign corporation) requires the filing of a written statement jointly executed by the controlling U.S. shareholders of the CFC within 180 days after the close of the taxable year of the CFC.
23.	Sec. 982(c)(2)(A)	Any person to whom a formal document request is mailed shall have the right to bring a proceeding to quash such request not later than the 90th day after the day such request was mailed.

	Statute or Regulation	Act Postponed
24.	Treas. Reg. § 1.988–1(a)(7)(ii)	An election to have Treas. Reg. § 1.988–1(a)(2)(iii) apply to regulated futures contracts and nonequity options must be made on or before the first day of the taxable year, or if later, on or before the first day during such taxable year on which the taxpayer holds a contract described in section 988(c)(1)(D)(ii) and Treas. Reg. § 1.988–1(a)(7)(ii). A late election may be made within 30 days after the time prescribed for the election.
25.	Sec. 988(c)(1)(E)(iii)(V) (qualified fund) and Treas. Reg. § 1.988–1(a)(8)(i)(E)	A qualified fund election must be made on or before the first day of the taxable year, or if later, on or before the first day during such taxable year on which the partnership holds an instrument described in section 988(c)(1)(E)(i).
26.	Treas. Reg. § 1.988–3(b)	An election to treat (under certain circumstances) any gain or loss recognized on a contract described in Treas. Reg. § 1.988–2(d)(1) as capital gain or loss must be made by clearly identifying such transaction on taxpayer's books and records on the date the transaction is entered into.
27.	Treas. Reg. § 1.988–5(a)(8)(i)	Taxpayer must establish a record, and before the close of the date the hedge is entered into, the taxpayer must enter into the record for each qualified hedging transaction the information contained in Treas. Reg. §§ 1.988–5(a)(8)(i)(A) through (E).
28.	Treas. Reg. § 1.988–5(b)(3)(i)	Taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge.
29.	Treas. Reg. § 1.988–5(c)(2)	Taxpayer must identify a hedge and underlying stock or security under the rules of Treas. Reg. § 1.988–5(b)(3).
30.	Sec. 991	A corporation that elects IC-DISC treatment (other than in the corporation's first taxable year) must file Form 4876–A, *Election To Be Treated as an Interest Charge DISC* , with the regional service center during the 90-day period prior to the beginning of the tax year in which the election is to take effect.
31.	Sec. 991 and Treas. Reg. § 1.991–1(g)(2)	A corporation that filed a tax return as a DISC, but subsequently determines that it does not wish to be treated as a DISC, must notify the [district director] more than 30 days before the expiration of period of limitations on assessment applicable to the tax year.
32.	Sec. 992 and Treas. Reg. § 1.992–2(a)(1)(i)	A qualifying corporation must file Form 4876–A, or attachments thereto, containing the consent of every shareholder of the corporation to be treated as a DISC as of the beginning of the corporation's first taxable year.
33.	Sec. 992 and Treas. Reg. § 1.992–2(b)(2)	A qualifying corporation must file consents of the shareholders of the corporation to be treated as a DISC with the service center with which the DISC election was first filed, within 90 days after the first day of the taxable year, or within the time granted for an extension to file such consents.
34.	Sec. 992 and Treas. Reg. § 1.992–2(e)(2)(ii)	A corporation seeking to revoke a prior election to be treated as a DISC, must file a statement within the first 90 days of the taxable year in which the election is to take effect with the service center with which it filed the election or, if the corporation filed an annual information return, by filing the statement at the service center with which it filed its most

		recent annual information return.
35.	Sec. 992 and Treas. Reg. § 1.992–3(c)(3)	A DISC that receives notification that it failed to satisfy the 95 percent of gross receipts test or the 95 percent assets test, or both tests, for a particular taxable year, must make a corrective deficiency distribution within 90 days of the date of the first written notification from the IRS.
36.	Sec. 993 and Treas. Reg. § 1.993–3(d)(2)(i)(b)	A taxpayer must deliver export property outside the U.S. within one year of the date of sale or lease in order to generate DISC benefits from a qualifying export transaction.

	Statute or Regulation	Act Postponed
37.	Sec. 1445 Treas. Reg. § 1.1445–1	Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests* , must be filed by a buyer or other transferee of a U.S. real property interest, and a corporation, partnership, or fiduciary that is required to withhold tax. The amount withheld is to be transmitted with Form 8288, which is generally to be filed by the 20th day after the date of transfer.
38.	Sec. 1446	All partnerships with effectively connected gross income allocable to a foreign partner in any tax year must file forms 8804, *Annual Return for Partnership Withholding Tax,* and 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax,* on or before the 15 th day of the 4 th month following the close of the partnership's taxable year.
39.	Sec. 1446	Form 8813, *Partnership Withholding Tax Payment Voucher,* is used to pay the withholding tax under section 1446 for all partnerships with effectively connected gross income allocable to a foreign partner in any tax year. Form 8813 must accompany each payment of section 1446 tax made during the partnership's taxable year. Form 8813 is to be filed on or before the 15 th day of the 4 th, 6 th, 9 th, and 12 th months of the partnership's taxable year for U.S. income tax purposes.
40.	Sec. 6038A(d)(2) and Treas. Reg. § 1.6038A–4(d)(1)	A reporting corporation must cure any failure to furnish information or failure to maintain records within 90 days after the IRS gives notice of the failure to avoid the continuation penalty.
41.	Sec. 6038A(d)(2) and Treas. Reg. § 1.6038A–4(d)(1)	A reporting corporation must cure any failure to furnish information or failure to maintain records before the beginning of each 30-day period after expiration of the initial 90-day period to avoid additional continuation penalties.
42.	Sec. 6038A(e)(1) and Treas. Reg. § 1.6038A–5(b)	A reporting corporation must furnish an authorization of agent within 30 days of a request by the IRS to avoid a penalty.
43.	Sec. 6038A(e)(4)(A)	A reporting corporation must commence any proceeding to quash a summons filed by the IRS in connection with an information request within 90 days of the date the summons is issued.
44.	Sec. 6038A(e)(4)(B)	A reporting corporation must commence any proceeding to review the IRS's determination of noncompliance with a summons within 90 days of the IRS's notice of noncompliance.
45.	Sec. 6038A and Treas. Reg. § 1.6038A–3(b)(3)	A reporting corporation must supply an English translation of records provided pursuant to a request for production within 30 days of a request by the IRS for a translation to avoid a penalty.
46.	Sec. 6038A and Treas. Reg. § 1.6038A–3(f)(2)	A reporting corporation must, within 60 days of a request by the IRS for records maintained outside the United States, either provide the records to the IRS, or move them to the United States and provide the IRS with an index to the records to avoid a penalty.
47.	Sec. 6038A and Treas. Reg. § 1.6038A–3(f)(2)(i)	A reporting corporation must supply English translations of documents maintained outside the United States within 30 days of a request by the IRS for translation to avoid a penalty.
48.	Sec. 6038A and Treas. Reg. § 1.6038A–3(f)(4)	A reporting corporation must request an extension of time to produce or translate documents maintained outside the United States beyond the period specified in the regulations within 30 days of a request by the IRS to avoid a penalty.
49.	Sec. 6662(e) and Treas. Reg. § 1.6662–6(d)(2)(iii)(A)	A taxpayer must provide, within 30 days of a request by the IRS, specified "principal documents" regarding the taxpayer's selection and application of transfer pricing method to avoid potential penalties in the event of a final transfer pricing adjustment by the IRS. *See also* Treas. Reg. § 1.6666–6(d)(2)(iii)(C) (similar requirement re: background documents).
50.	Secs. 6038, 6038B, and 6046A	The filing of Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships,* for those taxpayers who do not have to file an income tax return. The form is due at the time that an income tax return would have been due had the taxpayer been required to file an income tax return.

SECTION 13. PARTNERSHIP AND S CORPORATION ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. §§ 1.442–1(b)(1) and (3) and 1.706–1(b)(8)	A partnership may obtain approval of the Commissioner to adopt, change or retain an annual accounting periods by filing Form 1128, *Application to Adopt, Change, or Retain a Tax Year,* with such time as provided in administrative procedures published by the Commissioner.

2.	Treas. Reg. § 1.743–1(k)(2)	A transferee that acquires, by sale or exchange, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange. A transferee that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner.
3.	Treas. Reg. § 1.754–1(c)(1)	Generally, a partnership may revoke a section 754 election by filing the revocation no later than 30 days after the close of the partnership taxable year with respect to which the revocation is intended to take effect.
4.	Treas. Reg. § 1.761–2(b)(3)	A partnership may generally elect to be excluded from subchapter K. The election will be effective unless within 90 days after the formation of the organization any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization and also advises the Commissioner that he has so notified all other members of the organization. In addition, an application to revoke an election to be excluded from subchapter K must be submitted no later than 30 days after the beginning of the first taxable year to which the revocation is to apply.
5.	Treas. Reg. § 1.761–2(c)	A partnership requesting permission to be excluded from certain provisions of subchapter K must submit the request to the Commissioner no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired.
6.	Sec. 1361(e)	In general, the trustee of the electing small business trust (ESBT) must file the ESBT election within the 2-month and 16-day period beginning on the day the stock is transferred to the trust. *See* Notice 97–12, 1997–1 C.B. 385.
7.	Treas. Reg. § 1.1361–1(j)(6)	The current income beneficiary of a qualified subchapter S trust (QSST) must make a QSST election within the 2-month and 16-day period from one of the dates prescribed in Treas. Reg. § 1.1361–1(j)(6)(iii).
8.	Treas. Reg. § 1.1361–1(j)(10)	The successive income beneficiary of a QSST may affirmatively refuse to consent to the QSST election. The beneficiary must sign the statement and file the statement with the IRS within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary.
9.	Treas. Reg. § 1.1361–3(a)(4)	If an S corporation elects to treat an eligible subsidiary as a qualified subchapter S subsidiary (QSUB), the election cannot be effective more than 2 months and 15 days prior to the date of filing the election.
10.	Treas. Reg. § 1.1361–3(b)(2)	An S corporation may revoke a QSUB election by filing a statement with the service center. The effective date of a revocation of a QSUB election cannot be more than 2 months and 15 days prior to the filing date of the revocation.
11.	Treas. Reg. § 1.1362–2(a)(2), (4)	If a corporation revokes its subchapter S election after the first 2½-months of its taxable year, the revocation will not be effective until the following taxable year. An S corporation may rescind a revocation of an S election at any time before the revocation becomes effective.
12.	Sec. 1362(b)(3)	If a corporation files a subchapter S election after the first 2½-months of a corporation's taxable year, that corporation will not be treated as an S corporation until the taxable year after the year in which the S election is made.
13.	Sec. 1378(b) and Treas. Reg. § 1.1378–1(c)	An S or electing S corporation may obtain the approval of the Commissioner to adopt, change or retain an annual accounting period by filing Form 1128, *Application to Adopt, Change, or Retain a Tax Year,* within such time as is provided in administrative procedures published by the Commissioner. See Rev. Procs. 2002–38 and 2002–39.

SECTION 14. PROCEDURE & ADMINISTRATION ISSUES

.01 Bankruptcy and Collection

	Statute or Regulation	Act Postponed
1.	Treas. Reg. §§ 301.6036–1(a)(2) and (3)	A court-appointed receiver or fiduciary in a non-bankruptcy receivership, a fiduciary in aid of foreclosure who takes possession of substantially all of the debtor's assets, or an assignee for benefit of creditors, must give written notice within ten days of his appointment to the IRS as to where the debtor will file his tax return.
2.	Secs. 6320(a)(3)(B), 6320(c) and Treas. Reg. §§ 301.6320–1(b), (c) and (f)	A taxpayer has 30 days after receiving a notice of a lien to request a Collection Due Process (CDP) administrative hearing. After a determination at the CDP hearing, the taxpayer may appeal this determination within 30 days to the United States Tax Court or a United States district court.
3.	Secs. 6330(a)(3)(B) and (d)(1) and Treas. Reg. §§ 301.6330–1(b), (c) and (f)	The taxpayer must request a Collections Due Process (CDP) administrative hearing within 30 days after the IRS sends notice of a proposed levy. After a determination at the CDP hearing, the taxpayer may appeal this determination within 30 days to the United States Tax Court or a United States district court.
4.	Sec. 6331(k)(1) and Treas. Reg. § 301.7122–1T(f)(2)(ii)	If a taxpayer submits a good-faith revision of a rejected offer in compromise within 30 days after the rejection, the Service will not levy to collect the liability before deciding whether to accept the revised offer.
5.	Sec. 7122(d)(2) and Treas. Reg. § 301.7122–T(e)(5)(i)	A taxpayer must request administrative review of a rejected offer in compromise within 30 days after the date on the letter of rejection.

.02 Information Returns

1.	Sec. 6050I	Any person engaged in a trade or business receiving more than $10,000 cash in one transaction (or 2 or more related transactions) must file an information return, Form 8300, *Report of Cash Payments over $10,000 Received in a Trade or Business* , by the 15th day after the date the cash was received. Additionally, a statement must be provided to the person with respect to whom the information is required to be furnished by Jan. 31st of the year following.
2.	Sec. 6050L	Returns relating to certain dispositions of donated property, Forms 8282, *Donee Information Return* , must be filed within 125 days of the disposition.

SECTION 14. PROCEDURE & ADMINISTRATION ISSUES—CONTINUED

.03 Miscellaneous

1.	Sec. 1314(b)	A taxpayer may file a claim for refund or credit of tax based upon the mitigation provisions of sections 1311 through 1314 if, as of the date a determination (as defined in section 1313(a)) is made, one year remains on the period for filing a claim for refund.
2.	Sec. 6015	A requesting spouse must request relief under section 6015 within 2 years of the first collection activity against the requesting spouse.
3.	Sec. 6411	Taxpayers applying for a tentative carryback adjustment of the tax for the prior taxable year must file Form 1139 (for corporations) or Form 1045 (for entities other than corporations) within 12 months after the end of such taxable year that generates such net operating loss, net capital loss, or unused business credit from which the carryback results.
4.	Sec. 6656(e)(2)	A taxpayer who is required to deposit taxes and fails to do so is subject to a penalty under section 6656. Under section 6656(e)(2), the taxpayer may, within 90 days of the date of the penalty notice, designate to which deposit period within a specified tax period the deposits should be applied.

SECTION 15. TAX CREDIT ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 1.42–5(c)(1)	The taxpayer must make certain certifications at least annually to the Agency.
2.	Treas. Reg. § 1.42–5(c)(1)(iii)	The taxpayer must receive an annual income certification from each lowincome tenant with documentation to support the certification.
3.	Treas. Reg. § 1.42–8(a)(3)(v)	The taxpayer and an Agency may elect to use an appropriate percentage under section 42(b)(2)(A)(ii)(I) by notarizing a binding agreement by the 5th day following the end of the month in which the binding agreement was made.
4.	Treas. Reg. § 1.42–8(b)(1)(vii)	The taxpayer and an Agency may elect an appropriate percentage under section 42(b)(2)(A)(ii)(II) by notarizing a binding agreement by the 5th day following the end of the month in which the tax-exempt bonds are issued.
5.	Sec. 42(d)(2)(D)(ii)(IV)	In order to claim section 42 credits on an existing building, section 42(d)(2)(B)(ii)(I) requires that the building must have been placed in service at least ten years before the date the building was acquired by the taxpayer. A building is not considered placed in service for purposes of section 42(d)(2)(B)(ii) if the building is resold within a 12-month period after acquisition by foreclosure of any purchase-money security interest.
6.	Sec. 42(g)(3)(A)	A building shall be treated as a qualified low-income building only if the project meets the minimum set aside requirement by the close of the first year of the credit period of the building.
7.	Sec. 42(h)(6)(J)	A low-income housing agreement commitment must be in effect as of the beginning of the year for a building to receive credit. If such a commitment was not in effect, the taxpayer has a one-year period for correcting the failure.
8.	Sec. 42(h)(1)(E) and (F)	The taxpayer's basis in the building project, as of the later of the date which is 6 months after the date the allocation was made or the close of the calendar year in which the allocation is made, must be more than 10 percent of the taxpayer's reasonably expected basis in the project.
9.	Sec. 47(c)(1)(C) and Treas. Reg. § 1.48–12(b)(2)	A taxpayer has a 24- or 60-month measuring period in which the requisite amount of rehabilitation expenditures have to be incurred in order to satisfy the "substantial rehabilitation" test.
10.	Treas. Reg. § 1.48–12(d)(7)	In the historic rehabilitation context, if the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the return on which the credit is claimed, the taxpayer must, prior to the last day of the 30th month, consent to extending the statute of limitations by submitting a written statement to the District Director.
11.	Sec. 1(d)(12)(A)(ii)(II) and 51A(d)(1)	An employer seeking the Work Opportunity Credit or the Welfare-to-Work Credit with respect to an individual must submit Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits*, to the State Employment Security Agency not later than the 21 st day after the individual begins work for the employer.

SECTION 16. TAX-EXEMPT BOND ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 1.25–4T(c)	On or before the date of distribution of mortgage credit certificates under a program or December 31, 1987, the issuer must file an election not to issue an amount of qualified mortgage bonds. An election may be revoked, in whole or on part, at any time during the calendar year in which the election was made.
2.	Treas. Reg. §§ 1.141–12(d)(3) and 1.142–2(c)(2)	An issuer must provide notice to the Commissioner of the establishment of a defeasance escrow within 90 days of the date such defeasance escrow is established in accordance with Treas. Reg. § 1.141–12(d)(1) or 1.142–2(c)(1).
3.	Sec. 142(d)(7)	An operator of a multi-family housing project for which an election was made under section 142(d) must submit to the Secretary an annual certification as to whether such project continues to meet the requirements of section 142(d).
4.	Sec. 142(f)(4) and Treas. Reg. § 1.142(f)(4)–1	A person engaged in the local furnishing of electric energy or gas (a local furnisher) that uses facilities financed with exempt facility bonds under section 142(a)(8) and expands its service area in a manner inconsistent with the requirements of sections 142(a)(8) and 142(f), may make an election to ensure that those bonds will continue to be treated as exempt facility bonds. The election must be filed with the IRS on or before 90 days after the date of the service area expansion that causes the bonds to cease to meet the applicable requirements.

5.	Sec. 146(f) and Notice 89–12	If an issuing authority's volume cap for any calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during such calendar year by such authority, such authority may elect to treat all (or any portion) of such excess as a carryforward for 1 or more carryforward purposes. Such election must be filed by the earlier of (1) February 15 of the calendar year following the year in which the excess amount arises, or (2) the date of issue of bonds issued pursuant to the carryforward election.
6.	Sec. 148(f)(3) and Treas. Reg. § 1.148–3(g)	An issuer of a tax-exempt municipal obligation must make any required rebate payment no later than 60 days after the computation date to which the payment relates. A rebate payment is paid when it is filed with the IRS at the place or places designated by the Commissioner. A payment must be accompanied by the form provided by the Commissioner for this purpose.
7.	Treas Reg. § 1.148–5(c)	An issuer of a tax-exempt municipal obligation must make a yield reduction payment on or before the date of required rebate installment payments as described in Treas. Reg. § 1.148–3(f), (g), and (h).
8.	Sec. 148(f)(4)(C)(xvi) and Treas. Reg. § 1.148–7(k)(1)	As issuer of a tax-exempt municipal obligation that elects to pay certain penalties in lieu of rebate must make any required penalty payments not later than 90 days after the period to which the penalty relates.
9.	Sec. 149(e)	An issuer of a tax-exempt municipal obligation must submit to the Secretary a statement providing certain information regarding the municipal obligation not later than the 15 th day of the 2 nd calendar month after the close of the calendar quarter in which the municipal obligation is issued.

SECTION 17. INQUIRIES

If you wish to recommend that other acts qualify for postponement, please write to the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division), CC:PA:APJP:B2, 1111 Constitution Avenue, NW, Washington, DC 20224. Please mark "7508A List" on the envelope. In the alternative, e-mail your comments to: *Notice.Comments@irscounsel. treas.gov.*

SECTION 18. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2001–53, 2001–2 C.B. 506 is superseded.

SECTION 19. EFFECTIVE DATE

This revenue procedure is effective for acts that may be performed on or after November 18, 2002.

SECTION 20. DRAFTING INFORMATION

The principal author of this revenue procedure is Marcy W. Mendelsohn of the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). For further information regarding this revenue procedure, contact Ms. Mendelsohn at (202) 622–4940 (not a toll-free call).

CHIEF COUNSEL ADVISORY 200734021

Internal Revenue Service (I.R.S.)
Chief Counsel Advisory (CCA)
Issue: August 24, 2007
May 23, 2007

Section 121 — One Time Exclusion of Gain from Sale of Principal Residence by Individual Who Has Attained Age 55

To: Associate Area Counsel (SBSE)
Attn: Susan S. Canavello, Managing Counsel, OCC New Orleans, LA
From: William A. Jackson, Chief Branch 05 (Income Tax & Accounting)
Subject: Destruction of Principal Residence for purposes of IRC section 121(d)(5)
This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND:

Taxpayer: ***

ISSUE

Absent an actual sale or exchange of the property, has the damage to Taxpayer's principal residence under the facts described below resulted in its "destruction" within the meaning of section 121(d)(5) of the Code, which is treated as a sale of the property for purposes of section 121?

CONCLUSION

For purposes of section 121(d)(5) of the Code, whether the destruction of a taxpayer's principal residence has occurred is a question of fact. Based on the facts of this case, the level of damage to Taxpayer's principal residence results in its destruction for purposes of section 121(d)(5) and thus, the property may be treated as sold for purposes of section 121.

FACTS

Taxpayer's property was substantially damaged as a result of a natural disaster. The property was damaged to such an extent, that it must practicably be rebuilt. Although components of the residential structure remain standing, subsequently enacted land use regulations essentially require deconstruction followed by elevation, total first floor and roof, and near total second floor reconstruction at an expense exceeding the fair market value of the entire property prior to the disaster. The fair market value of the property prior to the damage in question is estimated at $250,000. The fair market value after the disaster is estimated at $75,000. Taxpayer's adjusted tax basis in the property is $170,000, and the costs of repair are estimated at $359,000. Taxpayer received $359,000 in insurance and other proceeds, and will receive $40,000 in excludible section 139(g) hazard mitigation payments.

Taxpayer meets the ownership and use requirements of section 121(a) of the Code, and is aware that the recognition of gain may be deferred under the provisions of sections 1033(a)(2) and 1033(b). However, Taxpayer has inquired whether he may treat the involuntary conversion as itself a 'sale' under section 121(d)(5).

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived, including gain derived from dealings in property. See section 61(a)(3). The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); 1955-1 C.B. 207. Gross income does not, however, include receipts of all kinds. For example, recoveries of capital, or basis, or amounts representing compensation for damages of property, are not accessions to wealth unless they exceed basis.

Section 1016(a)(1) of the Code provides that proper adjustment shall be made to the basis of property for expenditures, receipts, losses, or other items properly chargeable to capital account.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain. Section 1011(a) provides generally that the adjusted basis for determining gain from the sale or other disposition of property is the basis determined under section 1012 (cost), adjusted as provided in section 1016. Under section 1016, basis is adjusted by expenditures, receipts, losses, and other items properly chargeable to capital account. Under section 1001(c), the entire amount of gain must be recognized, except as otherwise provided.

Section 1033(a)(2)(A) of the Code provides, in part, that if property (as a result of its destruction in whole or in part (emphasis added), theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money, and, during the period specified in section 1033(a)(2)(B), the taxpayer purchases property similar or related in service or use to the converted property, at the election of the taxpayer, gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property.

Section 121(a) provides that a taxpayer may exclude gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more. Under section 121(b) of the Code, the amount of gain excludable under section 121 is limited to $250,000 for single taxpayers and $500,000 for married taxpayers filing a joint return. Section 121(c) permits pro-ratable exclusions in the case of certain sales or exchanges occurring by reason of unforeseen circumstances (e.g., involuntary conversions).

Under section 121(d)(5)(A) (Involuntary Conversions) the destruction (emphasis added), seizure or condemnation of property is treated as a sale of the property for purposes of section 121. Section 121(d)(5)(B) provides that, in applying section 1033, the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to section 121, reduced by the amount of gain not included in gross income pursuant to section 121.

Under section 121(d)(5)(A) the destruction of property is treated as the sale of the property for purposes of section 121. The statute and legislative history are silent regarding the legislative intent behind the term "destruction" as used in section 121(d)(5)(A). Further, we have found no case law defining the term for purposes of section 121. Moreover, the term "destruction" is not specifically defined for other purposes in the Code. Absent Subtitle E (Alcohol, Tobacco and certain other excise taxes), the word "destruction" is only used in the Code where a section may expressly apply to either partial or total destruction. For example, many sections of the Code use the phrase "destruction in whole or in part" (such as, sections 143 (mortgage revenue bonds), 512(a)(3)(D) (unrelated business taxable income for exempt organizations), 1033 (involuntary conversions), 1231 (long-term capital gain includes involuntary conversions of property used in a trade or business). This suggests that the term destruction may encompass both partial and complete destruction when specified. However, the lack of this common phrase in section 121 may indicate that Congress specifically intended the deemed sale rule of section 121(d)(5)(A) to apply only to a complete destruction (emphasis added).

Other Code sections use the phrase "destruction or damage" (such as, sections 451(d) (destruction of crops) and 1400L (tax credit for New York Liberty Zone). This suggests that the term destruction is distinguishable from damage and does not encompass partial destruction.
Because section 121(d)(5)(A) does not expressly apply to a partial destruction, we read section 121 to apply solely to a complete destruction, e.g., in whole, of the residence. There is no definition of complete destruction in the Internal Revenue Code. Therefore, other sources must be referred to in determining the meaning of this term.

In construing a statute, courts generally seek the plain and literal meaning of its language. United States v. Locke, 471 U.S. 84 (1985). More specifically, words in a revenue act generally are interpreted in their "'ordinary, everyday senses.'" Commissioner v. Soliman, 506 U.S. 168, 174 (1993) (quoting Malat v. Riddell, 383 U.S. 569, 571 (1966) (quoting Crane v. Commissioner, 331 U.S. 1, 6 (1947))); see also Helvering v. Horst, 311 U.S. 112 (1940) ("common understanding and experience are the touchstones for the interpretation of revenue laws"). The meaning of the term destruction is "to ruin the structure" or "to put out of existence." Merrian-Webster Online Dictionary, http;//www.mw.com/dictionary/destruction (last visited Aug. 28, 2006). See James A. Ballentine, Ballentine's Law Dictionary, 3rd Edition 343 (1969) (defining destruction as "a wrecking, tearing down, breaking up, or burning up"). Cf. C.G. Willis, Inc. v. Commissioner, 41 T.C. 468 (1964) (stating that involuntary conversion within the meaning of section 1033(a), means that "the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes"); Rev. Rul. 80-175, 1980-2 C.B. 230; Williamette Indus., Inc. v. Commissioner, 118 T.C. 126 (2002).

The use of the term "destruction" in the above sources suggests that, in the case of a residence, complete destruction occurs when the residence is damaged to the extent that the remaining structure cannot be utilized to advantage in restoring the property to its prior condition. Thus, one factor to consider in determining if a complete destruction of a taxpayer's principal residence has occurred is whether, based on this plain and literal meaning of the term "destruction", the residence is damaged to the extent that the remaining structure cannot be utilized to advantage in restoring the property to its prior condition.

Another factor to consider in determining complete destruction of property is whether the cost of repair substantially exceeds the fair market value of the property prior to its damage. In such a case, it may not be economically feasible to repair property that has already sustained partial destruction. The lack of economic feasibility of repairing damaged property is a factor suggesting complete destruction of the property.

Although we have found no legal authorities under section 121 that consider the economic feasibility of repair in determining the destruction of property, it is helpful to consider authorities regarding involuntary conversions under section 1033. In Revenue Ruling 80-175, 1980-2 C.B. 230, taxpayers sold timber that had been damaged as a result of a hurricane. The ruling holds that gain from the sale of the damaged timber was eligible for nonrecognition under section 1033. The rationale in the ruling for including the downed timber as property that was involuntarily converted was that the sale of the downed timber was dictated by the damage caused by the hurricane: "the downed timber was not repairable, and was generally no longer useful to the taxpayer in the context of its original objective." The ruling distinguished this situation from the case in C.G. Willis, Inc. v. Commissioner, 41 T.C. 468 (1964), where the court considered application of section 1033 of the Code to the proceeds of the sale of a partially damaged ship, which, along with insurance proceeds, was reinvested by the taxpayer in property similar or related in service or use. The court in that case denied the claim for nonrecognition treatment because, since the ship was repairable, "[i]t cannot be said that the sale of the unrepaired ship was a RESULT of its partial destruction." 41 T.C. at 475.

Thus, in the context of section 1033, the lack of economic feasibility of repair can result in the sale of partially damaged property being treated as part of the involuntary conversion of the property. Similarly, it would seem reasonable to consider economic feasibility of repair of a damaged principal residence in determining whether the damage amounts to a complete destruction for purposes of section 121(d)(5).

Whether damage to a taxpayer's principal residence is sufficient to result in its destruction for purposes of section 121(d)(5) is a factual determination. In this particular case, there are sufficient facts and circumstances to conclude that Taxpayer's property was destroyed, in whole, as a result of the disaster. It is not required under the above rationale that the taxpayer's principal residence be completely destroyed by or at the time of the catastrophic event, only that its complete destruction be caused by such event. A residential structure that must be essentially deconstructed prior to reconstruction, has been destroyed for purposes of section 121(d)(5). From the information presented, it appears that Taxpayer's principal

residence was damaged to such an extent that the remaining structure cannot be utilized to meaningful advantage in restoring the property to its prior condition. The fact that Taxpayer will nonetheless choose to reconstruct his principal residence at the same location does not vitiate this conclusion. Further, the cost of repairing the Taxpayer's residence in this case substantially exceeds the fair market value of the residence prior to the catastrophic event, thus making repair economically unfeasible. The law does not require taxpayers to make uneconomic choices.

Assuming no additional basis adjustments or casualty loss considerations, Taxpayer's gain on the transaction/deemed sale is $189,000 (($359,000 - $170,000 = $189,000). Since this amount is less than $250,000, all gain may be excluded from such deemed 'sale' under section 121(a). Section 121(d)(5)(B) provides that, in applying section 1033, the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to section 121 ($359,000), reduced by the amount of gain not included in gross income pursuant to section 121 ($189,000), or $170,000, which is Taxpayer's basis in the property. Accordingly, for purposes of section 1033, were it to be applicable, Taxpayer has no gain to defer.

EXCHANGES BY ENTITIES

JOSEPH R. BOLKER V. COMMISSIONER, CITE AS 56 AFTR 2D 85-5121 (760 F.2D 1039)

Case Information:

Code Sec(s):	7482
Court Name:	U.S. Court of Appeals, Ninth Circuit,
Docket No.:	No. 84-7357,
Date Decided:	05/17/1985
Prior History:	81 TC 782(No. 48)(opinion by Wilbur,*J.*) affirmed.
Tax Year(s):	Years 1972, 1973.
Disposition:	Decision for Taxpayer.
Cites:	56 AFTR 2d 85-5121, 760 F2d 1039, 85-1 USTC P 9400.

Richards, Watson, Dreyfuss & Gershon, Gilbert Dreyfuss, Los Angeles, Calif., Attys. for Appellee.
Raymond Hepper, Atty., Dept. of Justice, Wash., D.C., for Appellant.
On appeal from the United States Tax Court.

Before BOOCHEVER and BEEZER, Circuit Judges, and HARDY,[*] District Judge.
Judge: BOOCHEVER, Circuit Judge:

Opinion

Bolker was the sole shareholder of the Crosby Corporation (Crosby) which owned the Montebello property. For tax purposes associated with the anticipated development of the property, Bolker decided to liquidate Crosby and distribute Montebello to himself. Before Crosby carried out the liquidation, problems in financing convinced Bolker to dispose of the Montebello property rather than developing it himself. On the day the Crosby liquidation actually occurred, Bolker contracted to exchange Montebello with Southern California Savings & Loan (SCS) for other like-kind investment property to be designated. This exchange took place three months later. Bolker asserted, and the Tax Court agreed, that the exchange qualified for nonrecognition [pg. 85-5122] treatment under I.R.C. §1031(a). [1] Bolker v. Commissioner, 81 T.C. 782 (1983). The Commissioner appeals. Because we believe that Bolker held the Montebello property for investment within the meaning of section 1031(a), we affirm.

The transaction was consummated as follows. In March 1972, Bolker commenced the liquidation of Crosby. On March 13, 1972, all of the following occurred:

((1)) Crosby transferred all its assets and liabilities to Bolker in redemption of all Crosby stock outstanding;
((2)) Bolker as president of Crosby executed the Internal Revenue Service liquidation forms;

((3)) A deed conveying Montebello from Crosby to Bolker was recorded;

((4)) Bolker and Parlex, a corporation formed by Bolker's attorneys to facilitate the exchange, executed a conract to exchange Montebello for properties to be designated by Bolker;

((5)) Parlex contracted to convey Montebello to SCS in coordination with the exchange by Bolker and Parlex; and

((6)) Bolker, Crosby, Parlex, and SCS entered into a settlement agreement dismissing a breach of contract suit pending by Crosby against SCS in the event that all the other transactions went as planned. [2]

On June 30, 1972, all the transactions closed simultaneously, SCS receiving Montebello and Bolker receiving three parcels of real estate which he had previously designated.

Bolker reported no gain on the transaction, asserting that it qualified for nonrecognition under then-current I.R.C. §1031(a):

No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

The Commissioner sent Bolker statutory notices of deficiency on the ground that the transaction did not qualify under section 1031(a). In the Tax Court, the Commissioner argued two theories: that Crosby, not Bolker, exchanged Montebello with SCS, and in the alternative, that Bolker did not hold Montebello for productive use in trade or business or for investment. [3] The Tax Court rejected both arguments. The Commissioner does not appeal the decision that Bolker individually made the exchange. The Commissioner does not challenge any of the Tax Court's findings of fact; review of the Tax Court's decisions of law is de novo. California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 [50 AFTR2d 82-5271] (9th Cir. 1982).

I. Stock For Property

Section 1031(a) specifically excludes from eligibility for nonrecognition an exchange involving stock. The Commissioner argues that Bolker's transactions should properly be viewed as a whole, under the step transaction doctrine, see Commissioner v. Court Holding Co., 324 U.S. 331, 334 [33 AFTR 593] (1945) (court may view transaction as a whole even if taxpayer accomplishes result by series of steps), and that so viewed, Bolker exchanged his Crosby stock for property. The Commissioner did not argue this theory in the Tax Court.

[1] As a general rule, we will not consider an issue raised for the first time on appeal, United States v. Greger, 716 F.2d 1275, 1277 (9th Cir. 1983)(taxpayer argued for first time on appeal that statute prohibiting assistance in preparation of false return cannot apply if preparer is innocent), cert. denied, 104 S. Ct. 1002 (1984), although we have the power to do so, see Hormel v. Helvering, 312 U.S. 552, 557-59 [25 AFTR 1198] (1941). This circuit has recognized three exceptions to this rule: in the "exceptional" case in which review is necessary to prevent a miscarriage of justice or to preserve the integrity of the judicial process, see Greger, 716 F.2d at 1277, when a new issue arises while appeal is pending because of a change in the law, see United States v. Whitten, 706 F.2d 1000, 1012 (9th Cir. 1983) (objection to plain view search first raised on appeal), cert. denied, 104 S. Ct. 1593 (1984), or when the issue presented is purely one of law and either does not depend on the factual record developed below, or the pertinent record has been developed, see United [pg. 85-5123] States v. Patrin, 575 F.2d 708, 712 (9th Cir. 1978) (on appeal of conviction for assaulting federal officers in performance of their duties, government could not rely on a different statute defining federal officers than at trial because defendants might have tried their case differently in response). If one of the exceptions is applicable, we have discretion to address the issue.

The Commissioner contends that the third exception applies in this case. Although a determination based on the step transaction doctrine would require reliance on the factual record, the Commissioner argues that the record is fully developed and that we could decide the issue on appeal without prejudice to Bolker's right at trial to present relevant facts. See id. at 712-13. Application of the step transaction doctrine requires a detailed factual inquiry, however, and there may be facts relevant to the issue which were not developed in the record. Moreover, Bolker's tactics, presentation of the facts, and legal arguments at trial might have been different if the Commissioner had argued the step transaction issue below. [4] We therefore decline to address the issue on appeal.

II. The Holding Requirement

The Commissioner argued unsuccessfully in the Tax Court that because Bolker acquired the property with the intent, and almost immediate contractual obligation, to exchange it, Bolker never held the property for productive use in trade or business or for investment as required by section 1031(a). Essentially, the Commissioner's position is that the holding requirement has two elements: that the taxpayer own the property to make money rather than for personal reasons, and that at some point before the taxpayer decides to exchange the property, he have intended to keep that property as an investment.

Bolker argues that the intent to exchange investment property for other investment property satisfies the holding requirement. Bolker's position also in essence posits two elements to the holding requirement: that the taxpayer own the property to make money, and that the taxpayer not intend to liquidate his investment.

[2] Authority on this issue is scarce. This is not surprising, because in almost all fact situations in which property is acquired for immediate exchange, there is no gain or loss to the acquiring taxpayer on the exchange, as the property has not had time to change in value. Therefore, it is irrelevant to that taxpayer whether section 1031(a) applies. See, e.g., D. Posin, Federal Income Taxation 180 & n.46 (1983); Rev.Rul. 77-297, 1977-2 C.B. 304, 305. The cases generally address the taxpayer's intent regarding the property *acquired* in an exchange, rather than the property*given up.* The rule of those cases, e.g., Regals Realty Co. v. Commissioner, 127 F.2d 931, 933-34 [29 AFTR 444] (2d Cir. 1942), is that at the time of the exchange the taxpayer must intend to keep the property acquired, and intend to do so with an investment purpose. That rule would be nonsense as applied to the property given up, because at the time of the exchange the taxpayer's intent in every case is to give up the property. No exchange could qualify.

The Commissioner cites two revenue rulings to support his position, Rev.Rul. 77-337, 1977-2 C.B. 305, and Rev.Rul. 77-297. Revenue rulings, however, are not controlling. Ricards v. United States, 683 F.2d 1219, 1224 & n.12 [50 AFTR2d 82-6223] (9th Cir. 1981)(revenue rulings not binding although entitled to consideration as "body of experience and informed judgment"). Moreover, neither ruling is precisely on point here. In Revenue Ruling 77-337, A owned X corportion, which owned a shopping center. Pursuant to a prearranged plan, A liquidated X to acquire the shopping center so that he could immediately exchange it with B for like-kind property. A never held the shopping center, and therefore section 1031(a) did not apply. This case differs from 77-337 in two ways. First, the liquidation was planned before any intention to exchange the properties arose, not to facilitate an exchange. Second, Bolker did actually hold Montebello for three months.

In Revenue Ruling 77-297, B wanted to buy A's ranch, but A wanted to exchange rather than sell. A located a desirable ranch owned by C. Pursuant to a prearranged plan, B purchased C's ranch and immediately exchanged it with A for A's [pg. 85-5124] ranch. As to A, the exchange qualifies under section 1031(a). As to B, it does not, since B never held C's ranch, and acquired it solely to exchange. The same distinctions as in 77-337 apply between this ruling and the facts in Bolker. Neither ruling cites case authority for its holdings.

Bolker cites two cases that support his position. In each case, the Tax Court gave section 1031(a) nonrecognition to a transaction in which the property given up was acquired with the intention of exchange. However, neither case actually considered the holding issue, which diminishes the persuasiveness of the authority. In 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975), taxpayer owned an option to purchase real estate. Firemen's Fund Insurance Co. (Firemen's) wanted the property, but taxpayer preferred an exchange to a sale. Firemen's advanced taxpayer the money to exercise its option under a contract providing that taxpayer would exchange the property for property to be acquired by Firemen's. Id. at 8-11. Taxpayer exercised its option, and the exchange was consummated five months later when Firemen's had acquired property satisfactory to taxpayer. Id. at 12. The issue in the case was whether the transaction was the sale of the option to Firemen's, or an exchange of the property with Firemen's. The court held that it was an exchange, and therefore qualified under section 1031(a). Id. at 15. the court apparently never considered whether the fact

that the optioned property was acquired solely for exchange meant that it was held for investment under section 1031(a). Even without an explicit holding, however, the case does support Bolker's theory that an intent to exchange for like-kind property satisfies the holding requirement.
Rutherford v. Commissioner, T.C.M. 1978-505, [¶78,505 P-H Memo TC] 37 T.C.M. (CCH) 1851-77, is an unusual case with a holding similar to 124 Front Street. W, a cattle breeder, agreed with R, another breeder, to exchange W's twelve half-blood heifers for twelve three-quarter blood heifers to be bred from the half-blood heifers. W gave R the twelve half-blood heifers. R bred them to a registered bull and gave W the first twelve three-quarter blood heifers produced. Id. at 1851-77 to 1851-78. At stake in the case were depreciation deductions. En route to determining R's basis in the half-blood heifers for depreciation purposes, the Tax Court held that the exchange of heifers qualified for nonrecognition under section 1031(a). Id. at 1851-79. Although the court did not even mention the point, the facts indicate that when by virtue of their birth R "acquired" the three-quarter blood heifers, the property he gave up, he had already contracted to exchange them. Thus, Rutherford also supports Bolker's position, albeit tacitly.

The Tax Court's holding in this case is based on its recent opinion in Magneson v. Commissioner, 81 T.C. 767 (1983) (court reviewed), aff'd, No. 84-7069 [55 AFTR2d 85-911], (9th Cir. Feb. 20, 1985). In Magneson, taxpayers exchanged property for like-kind property and then by prearrangement contributed the property they acquired to a partnership. Each transaction viewed separately was admittedly tax-free, but in combination raised the issue whether contribution to a partnership satisfies the holding requirement for the acquired property. The Bolker Tax Court interpreted Magneson as holding that an intent to continue the investment rather than selling it or converting it to personal use satisfied the holding requirement, even if the taxpayer never intended to keep the specific property acquired. In both Bolker and Magneson, the Tax Court emphasized the admitted nonrecognition treatment accorded each individual step in the transactions, and reasoned that if each step were tax-free, in combination they should also be tax-free, so long as the continuity of investment principle underlying section 1031(a) is respected. See Bolker, 81 T.C. at 805-06; Magneson, 81 T.C. at 771.

We recently affirmed Magneson but our rationale differed from that of the Tax Court. While we recognized the importance of continuity of investment as the basic purpose underlying section 1031(a), see H.R. Rep. No. 704, 73d Cong., 2d Sess. 12, reprinted in 1939-1 C.B. (pt. 2) 554, 564, we did not hold that that principle justifies the failure to address the specific requirements of section 1031(a). Rather, we based affirmance on our holding that the Magnesons intended to and did continue to hold the acquired property, the contribution to the partnership being a change in the form of ownership rather than the relinquishment of ownership. Magneson, slip op. at 9-13. Thus the Magnesons satisfied the specific requirements of section 1031(a). Nothing in Magneson relieves Bolker of his burden to satisfy the requirement that he have held the property given up, Montebello, for investment.

Finally, there is nothing in the legislative history which either supports or negates Bolker's or the Commissioner's position. In sum, the Commisioner is supported by two revenue rulings which are neither controlling nor precisely on point. Bolker is supported by two Tax Court decisions which [pg. 85-5125] did not explicitly address this issue. In the absence of controlling precedent, the plain language of the statute itself appears our most reliable guide.

The statute requires that the property be "held for productive use in trade or business or for investment." Giving these words their ordinary meaning, see Greyhound Corp. v. United States, 495 F.2d 863, 869 [33 AFTR2d 74-1534] (9th Cir. 1974) (if Code does not define term, court should give words their ordinary meaning), a taxpayer may satisfy the "holding" requirement by owning the property, and the "for productive use in trade or business or for investment" requirement by lack of intent either to liquidate the investment or to use it for personal pursuits. These are essentially the two requirements courts have placed on the property acquired in a section 1031(a) exchange, see, e.g., Regals Realty, 127 F.2d at 933-34 (intent to sell disqualifies exchange); Click v. Commissioner, 78 T.C. 225, 233-34 (1982) (intent to give as gift disqualifies exchange), so this interpretation would yield the symmetry the use of identical language seems to demand.

The Commissioner's position, in contrast, would require us to read an unexpressed additional requirement into the statute: that the taxpayer have, previous to forming the intent to exchange one piece of property for a second parcel, an intent to keep the first piece of property indefinitely. We decline to do so. See Starker v. United States, 602 F.2d 1341, 1352-53[44 AFTR2d 79-5525] (9th Cir. 1979) (refusing to read unexpressed additional requirement of simultaneous exchange into §1031(a)). [5] Rather, we hold that if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is "holding" that property "for productive use in trade or business or for investment" within the meaning of section 1031(a). Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement, because it is*not* an intent to liquidate the investment or to use it for personal pursuits. Bolker acquired the Montebello property with the intent to exchange it for like-kind property, and thus he held for investment under section 1031(a). The decision of the Tax Court is therefore Affirmed.

[*]

Honorable Charles L. Hardy, United States District Judge for the District of Arizona, sitting by designation.

[1]

All references to the Internal Revenue Code are to the Internal Revenue Code of 1954 as amended and in force in 1972.

[2]

Crosby had filed a breach of contract suit against SCS in 1971 based upon SCS' failure to fulfill a prior contract to purchase Montebello. We do not discuss whether the settlement of this lawsuit as part of the transaction was an exchange of non-like-kind property, because the Commissioner did not raise the argument at trial or on appeal. See discussion Part I below.

[3]

The Commissioner concedes that the real estate received by Bolker was of like kind to the Montebello property.

[4]

At trial, the Commissioner argued that in substance the exchange of Montebello was negotiated and carried out by the corporation, and that the corporation, not Bolker, should be taxed on any gain realized. The Commissioner's evidence was directed toward proving that the exchange was the

continuation and culmination of the 1969 corporate plan to sell Montebello, disguised as a liquidation and exchange to avoid tax consequences to the corporation. Bolker's evidence was directed toward proving that the corporate plan to sell Montebello had been abandoned, and that the 1971 negotiations were by Bolker as an individual despite the fact that Crosby still owned Montebello.

[5]

Starker's specific holding that section 1031(a) does not require simultaneous exchange, 602 F.2d at 1354-55, has been limited by a revision of section 1031(a). Deficit Reduction Act of 1984, Pub. L. No. 98-369, §77, 98 Stat. 494, 595 (effective July 19, 1984; requiring that property acquired be designated and exchanged within 180 days after taxpayer transfers the property given up). The addition of this requirement, specifically drafted in response to Starker, see H.R. Rep. No. 432, 98th Cong., 2d Sess. 1231, reprinted in 6B 1984 U.S. Code Cong. & Ad. News 1, 201, does not affect the validity of Starker's refusal to read unexpressed requirements into the then-current version of section 1031(a).

COMMISSIONER V. COURT HOLDING CO., CITE AS 33 AFTR 593 (65 S.CT. 707)

Case Information:
Code Sec(s):
Court Name: U.S. Supreme Court.
Docket No.: No. 581.
Date Argued: 02/26/1945
Date Decided: 03/12/1945
Disposition:
Cites: 33 AFTR 593, 324 US 331, 65 S Ct 707, 89 L Ed 981, 45-1 USTC P 9215.

OPINION

Mr. Samuel O. Clark, Jr., Asst. Atty. Gen., for petitioner.
Mr. Maurice Kay, of Washington, D. C., for respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

Petition by Court Holding Company to review a decision of the Tax Court of the United States, 2 T.C. 531, redetermining a deficiency in tax imposed by the Commissioner of Internal Revenue. The Circuit Court of Appeals, 143 F.2d 823, reversed the decision of the Tax Court, and the Commissioner of Internal Revenue brings certiorari.

Decision of Circuit Court of Appeals reversed and decision of Tax Court affirmed.

Judge: Mr. Justice BLACK delivered the opinion of the Court.

An apartment house, which was the sole asset of the respondent corporation, was transferred in the form of a liquidating dividend to the corporation's two shareholders. They in turn formally conveyed it to a purchaser who had originally negotiated for the purchase from the corporation. The question is whether the Circuit Court of Appeals properly reversed [1] the Tax Court's conclusion [2] that the corporation was taxable under Section 22 of the Internal Revenue Code [3] for the gain which accrued from the sale. The answer depends upon whether the findings of the [pg. 594] Tax Court that the whole transaction showed a sale by the corporation rather than by the stockholders were final and binding upon the Circuit Court of Appeals.

It is unnecessary to set out in detail the evidence introduced before the Tax Court of its findings. Despite conflicting evidence, the following findings of the Tax Court are supported by the record:

The respondent corporation was organized in 1934 solely to buy and hold the apartment building which was the only property ever owned by it. All of its outstanding stock was owned by Minnie Miller and her husband. Between October 1, 1939 and February, 1940, while the corporation still had legal title to the property, negotiations for its sale took place. These negotiations were between the corporation and the lessees of the property, together with a sister and brother-in-law. An oral agreement was reached as to the terms and conditions of sale, and on February 22, 1940, the parties met to reduce the agreement to writing. The purchaser was then advised by the corporation's attorney that the sale could not be consummated because it would result in the imposition of a large income tax on the corporation. The next day, the corporation declared a "liquidating dividend", which involved complete liquidation of its assets, and surrender of all outstanding stock. Mrs. Miller and her husband surrendered their stock, and the building was deeded to them. A sale contract was then drawn, naming the Millers individually as vendors, and the lessees' sister as vendee, which embodied substantially the same terms and conditions previously agreed upon. One thousand dollars, which a month and a half earlier had been paid to the corporation by the lessees, was applied in part payment of the purchase price. Three days later, the property was conveyed to the lessees' sister.

The Tax Court concluded from these facts that, despite the declaration of a "liquidating dividend" followed by the transfers of legal title, the corporation had not abandoned the sales negotiations; that these were mere formalities designed "to make the transaction appear to be other than what it was", in order to avoid tax liability. The Circuit Court of Appeals drawing different inferences from the record, held that the corporation had "called off" the sale, and treated the stockholders' sale as unrelated to the prior negotiations.

[1-6] There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. Dobson v. Commissioner of Internal Revenue, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248; Commissioner of Internal Revenue v. Heininger, 320 U.S. 467, 64 S.Ct. 249, 88 L.Ed. 171; Commissioner of Internal Revenue v. Scottish American Investment Co., 323 U.S. 119, 65 S.Ct. 169, On the basis of these findings, the Tax Court was justified in attributing the gain from the sale to respondent corporation. The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. [4] To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

It is urged that respondent corporation never executed a written agreement, and that an oral agreement to sell land cannot be enforced in Florida because of the Statute of Frauds, Comp.Gen.Laws of Florida, 1927, vol. 3, Sec. 5779, F.S.A. § 725.01. But the fact that respondent corporation itself

never executed a written contract is unimportant, since the Tax Court found from the facts of the entire transaction that the executed sale was in substance the sale of the corporation. The decision of the Circuit Court of Appeals is reversed, and that of the Tax Court affirmed.

It is so ordered.

Reversed.

[1]

5 Cir., 143 F.2d 823.

[2]

2 T. C. 531.

[3]

Profits from the sale of property are taxable as income under Section 22(a) of the Internal Revenue Code, 26 U.S.C. § 22, 26 U.S.C.A. Int.Rev.Code, § 22(a). The Treasury Regulations have long provided that gains accruing from the sales of a corporation's assets, in whole or in part, constitute income to it, but that a corporation realizes no taxable gain by a mere distribution of its assets in kind, in partial or in complete liquidation, however much they may have appreciated in value since acquisition. Secs. 19.22(a)-19, 19.22(a)-21, Treasury Regulations 103.

[4]

Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596, 97 A.L.R. 1355; Minnesota Tea Co. v. Helvering, 302 U.S. 609, 58 S.Ct. 393, 82 L.Ed. 474; Griffiths v. Helvering, 08 U.S. 355, 60 S.Ct. 277, 84 L.Ed. 319; Higgins v. Smith, 308 U.S. 473, 60 S.Ct. 355, 84 L.Ed. 406.

NORMAN J. MAGNESON AND BEVERLY G. MAGNESON v. COMMISSIONER, CITE AS 55 AFTR 2D 85-911 (753 F.2D 1490)

Case Information:

Code Sec(s):	1031
Court Name:	U.S. Court of Appeals, Ninth Circuit,
Docket No.:	No. 84-7069,
Date Decided:	02/20/1985
Prior History:	81 TC 767 (No. 47) (opinion by Goffe, *J.*) affirmed.
Tax Year(s):	Year 1977.
Disposition:	Decision for taxpayer.
Cites:	55 AFTR 2d 85-911, 753 F2d 1490, 85-1 USTC P 9205.

Thomas W. Beetles, Post, Kirby, Noonan & Sweat, 701 B St., Suite 1400, San Diego, Calif., Attys. for Appellee.
Glenn L. Archer, Jr., Asst. Atty. Gen., Michael L. Paup, Richard Farber, Raymond W. Hepper, Attys., Tax Div., Dept. of Justice, Wash., D.C., for Appellant.

On appeal from the United States Tax Court.
Before WALLACE and BOOCHEVER, Circuit Judges, and JAMESON,[*] District Judge.
Judge: BOOCHEVER, Circuit Judge: [pg. 85-912]

Opinion

We are faced in this case with an issue of first impression in the Courts of Appeals: whether property acquired in a like-kind exchange with the intention of contributing it to a partnership under Internal Revenue Code §721 is "held" for investment within the meaning of Internal Revenue Code §1031(a).

Petitioners Norman and Beverly Magneson exchanged a fee interest in one piece of real estate for a fee interest in another. The same day they contributed the acquired real estate to a limited partnership in return for a general partnership interest. The Magnesons claim nonrecognition of gain on both the exchange and the contribution under sections 1031(a) and 721 of the Internal Revenue Code.[1] The Tax Court held that the taxpayers qualified for nonrecognition, 81 T.C. 767 (1983), and the Commissioner appeals. We affirm.

The Magnesons were the sole owners of an apartment building in San Diego, California (Iowa Street Property). They held the property for productive use in trade or business or for investment within the meaning of section 1031(a). N.E.R. Plaza, Ltd. (NER) was the sole owner of commercial property in San Diego, California, known as the Plaza Property (Plaza Property).

Pursuant to a prearranged transaction consummated on August 11, 1977, the Magnesons transferred their fee interest in the Iowa Street Property to NER in exchange for a ten-percent undivided fee interest in the Plaza Property. Thereafter, on the same day, both the Magnesons and NER transferred their interests in the Plaza Property to U.S. Trust, Ltd. (U.S. Trust), a limited partnership under California law. In exchange for cash and their ten-percent interest in the Plaza Property, the Magnesons received a general partnership interest in U.S. Trust consisting of a ten-percent equity interest and a nine-percent interest in net profits and losses. U.S. Trust was formed for the purpose of acquiring, holding, and operating the Plaza Property. The Magnesons paid no tax on the gain realized from their exchange of the Iowa Street Property for the Plaza Property, claiming nonrecognition treatment under section 1031(a). They also paid no tax on the gain realized from their contribution of the Plaza Property to U.S. Trust, claiming nonrecognition treatment under section 721.

The parties agree that the contribution of the Plaza Property to U.S. Trust qualifies for nonrecognition of gain under section 721, which provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." The parties also agree that the Iowa Street Property and the Plaza Property are like-kind properties within the meaning of section 1031(a), which in 1977 provided:

No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

For purposes of this opinion we will use the phrase "held for investment" when discussing the holding requirement of section 1031(a), because the distinction between productive use and investment is not at issue.

(I.) The Holding Requirement Of Section 1031(a) [1] The Commissioner argues that the exchange of the Iowa Street Property for the Plaza Property cannot qualify for nonrecognition under section 1031(a) because the Magnesons did not "hold" the Plaza Property for investment. The Magnesons contend that holding the property to contribute to a partnership is "holding" the property for investment. The court found for the Magnesons. The majority concluded that the contribution of the Plaza Property to U.S. Trust was a continuation of the Magnesons' investment unliquidated but in a modified form, and that therefore the Magnesons did hold the Plaza Property for investment. 81 T.C. at 771-72. We review the Tax Court's conclusions of law de novo, noting however that its opinions are entitled to respect because of its special expertise in the field. California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 [50 AFTR2d 82-5271] (9th Cir. 1982).To qualify for nonrecognition treatment under section 1031(a), the taxpayer must, at the time the exchange is consummated, intend to hold the property acquired for investment. Regals Realty Co. v.

Commissioner, 127 F.2d 931, 934 [29 AFTR 444] (2d Cir. 1942); see Margolis v. Commissioner, 337 F.2d 1001, 1003-05 [14 AFTR2d 5667] (9th Cir. 1964). Numerous cases have held that the taxpayers' intent at the time of the exchange to liquidate their interest in the property acquired disqualifies the exchange from nonrecognition under section 1031(a). See, e.g., Regals Realty, 127 F.2d at 933-34 (intent to sell); Click v. Commissioner, 78 T.C. 225, 233-34 (1982) (intent to give as gift); Lindsley v. Commissioner, T.C.M. (P-H) 1983-729, at 3047-48 (intent to give to charity); Land Dynamics v. Commissioner, T.C.M. (P-H) 1978-259, at 1107-08 (intent to sell). But see Wagensen v. Commissioner, 74 T.C. 653, 658-59 (1980) (intent at time of exchange to hold for productive use not negated by desire to give eventually to children). It is stipulated that the Magnesons intended at the time of the exchange to hold the property for contribution to U.S. Trust. Therefore, the Magnesons' exchange can only qualify under section 1031(a) if contributing property to a partnership in return for an interest in the partnership is "holding" the property for investment within the meaning of section 1031(a). [pg. 85-913] We have found no precedent on point at either the Tax Court or the circuit court level. Revenue Ruling 75-292, 1975-2 C.B. 333, relied on by the Commissioner, addresses a related question: whether a like-kind exchange followed by a transfer for stock under section 351 [2] to a controlled corporation qualifies for nonrecognition under section 1031(a). The Service ruled that the property transferred to the corporation was no longer held by the taxpayer, and gain was recognized on the exchange. Id. at 334. Revenue rulings, however, are not binding on this court. Ricards v. United States, 683 F.2d 1219, 1224 & n.12 [50 AFTR2d 82-6223] (9th Cir. 1981) (rulings not dispositive although entitled to consideration as "body of experience and informed judgment"). More significantly, transfer to a corporation in exchange for shares is distinguishable from transfer to a partnership for a general partnership interest in several important ways.First, a corporation is a distinct entity, apart from its shareholders, whereas a partnership is an association of its partner-investors. Shareholders have no ownership interest in the assets of a corporation; partners own the assets of a partnership. Shareholders have no participation in daily management of corporate assets and very little participation in long-term management; general partners are the managers of the partnership. Thus when the owner of property transfers it to a corporation in exchange for shares, he relinquishes ownership and control of the property. In contrast, he retains both in a transfer to a partnership for a general partnership interest.Second, a like-kind exchange followed by a section 351 transfer, viewed as a whole, results in the exchange of property for stock. The parenthetical clause of section 1031(a) expressly excludes stock as property eligible for exchange, but there is no such prohibition on exchange of partnership interests. Long v. Commissioner, 7 T.C. 1045, 1066-68 (1981) (rejecting Commissioner's argument that partnership interests fit within exclusionary clause as choses in action or evidences of interests). Revenue Ruling 75-292 is therefore inapplicable to this case.The central purpose of both sections 721 and 1031(a), as stated by the Treasury Regulations, is to provide for nonrecognition of gain on a transfer of property in which the differences between the property parted with and the property acquired "are more formal than substantial," and "the new property is substantially a continuation of the old investment still unliquidated." Treas. Reg. 1.1002-1(c), T.D. 6500, 25 Fed. Reg. 11910 (1960). [3] The regulations [pg. 85-914] reflect the legislative history of the predecessor of section 1031(a). See H.R. Rep. No. 704, 73d Cong., 2d Sess. 12, reprinted in 1939-1 C.B. (pt. 2) 554, 564; Starker v. United States, 602 F.2d 1341, 1352 [44 AFTR2d 79-5525] (9th Cir. 1979) (section 1031 "designed to avoid the imposition of a tax on those who do not 'cash in' their investments in trade or business property"). Furthermore, as the Tax Court noted, the regulations unequivocally describe section 721 as representing a continuation, not a liquidation, of the old investment. The case law, the regulations, and the legislative history are thus all in agreement that the basic reason for nonrecognition of gain or loss on transfers of property under sections 1031 and 721 is that the taxpayer's economic situation after the transfer is fundamentally the same as it was before the transfer: his money is still tied up in investment in the same kind of property. Koch v. Commissioner, 71 T.C. 54, 63-64 (1978); see Starker, 602 F.2d at 1352; Biggs v. Commissioner, 69 T.C. 905, 913-14 (1978), aff'd, 632 F.2d 1171 [47 AFTR2d 81-484] (5th Cir. 1980). This principle exactly describes the Magnesons' situation. Before the two transactions, their investment was a fee interest in income-producing real estate. They exchanged this property for other income-producing real estate, which they held as tenants in common with NER. The Magnesons and NER then changed the form of their ownership of that real estate from tenancy in common to partnership. They still own the income-producing real estate, and they have taken no cash or non-like-kind property out of the transaction. The Magnesons' transactions therefore fit squarely within the central purpose of section 1031.

They exchanged their investment property for like-kind investment property which they continue to hold for investment, albeit in a different form of ownership.The Commissioner, and the dissenting Tax Court judges, argue that the differences between ownership as tenants in common and ownership as a partnership are so substantial that the Magnesons cannot be regarded as having continued to hold the property for investment under section 1031(a) after the partnership contribution. Previous like-kind exchange cases have indeed looked to the nature of the taxpayer's ownership interest as well as to the nature of the property owned to determine if the section 1031(a) requirements are met. See Estate of Meyer v. Commissioner, 503 F.2d 556, 557-58 [34 AFTR2d 74-5771] (9th Cir. 1974) (per curiam) (general partnership and limited partnership interests not like-kind property); Pappas v. Commissioner, 78 T.C. 1078, 1086-87 (1982) (general partnership for general partnership qualifies as like-kind); Long, 77 T.C. at 1064-66 (joint venture for general partnership qualifies as like-kind); Gulfstream Land & Development Corp. v. Commissioner, 71 T.C. 587, 595 (1979) (joint venture for joint venture qualifies as like-kind); cf. M.H.S. Co. v. Commissioner, 575 F.2d 1177, 1178 [41 AFTR2d 78-1398] (6th Cir. 1978) (section 1033 condemnation and reinvestment; real property proceeds put into joint venture owning real property; not like-kind because state law converted all joint venture property into personal property of investors so exchange was real for personal and not like-kind); Koch, 71 T.C. at 64-65 (unencumbered fee for fee subject to 99-year leasehold interest qualifies as like-kind).In application of federal tax statutes, state law controls in determining the nature of the legal interest the taxpayer holds in the property sought to be taxed. Federal law does not create or define property rights; it merely attaches tax consequences to the interests created by state law. Aquilino v. United States, 363 U.S. 509, 512-13 [5 AFTR2d 1698] (1960). The dissent and the majority therefore correctly looked to California law to determine and compare the nature of tenancy in common and partnership ownership.In California, a tenant in common owns an undivided interest in and is entitled to possession and enjoyment of the entire [pg. 85-915] property. Dimmick v. Dimmick, 58 Cal. 2d 417, 422, 374 P.2d 824, 826, 24 Cal. Rptr. 856, 858 (1962). Title to his interest is vested in him, he may encumber it or sell it independently of his co-tenants, Meyer v. Wall, 270 Cal. App. 2d 24, 30, 75 Cal. Rptr. 236, 240 (1969), and the interest is devisable and descendible, see Wilkerson v. Thomas, 121 Cal. App. 2d 479, 482, 263 P.2d 678, 680 (1953). Similarly, a partner is co-owner with his partners, as a tenant in partnership, of specific partnership property. Cal. Corp. Code §15025(1) (West Supp. 1984). A general partner has the right to possess partnership property for the purposes of the partnership, although title is not vested in him. Cal. Corp. Code §15025(2)(a) (West Supp. 1984). However, a partner's interest in specific partnership property is not assignable without concurrent assignment by all other partners, Cal. Corp. Code §15025(2)(b) (West Supp. 1984), nor subject to attachment except for partnership debt, Cal. Corp. Code §15025(2)(c) (West Supp. 1984), nor subject to marital property rights, Cal. Corp. Code §15025(2)(e) (West Supp. 1984). On the death of a partner, his interest in specific partnership property vests in the surviving partners, not in the deceased partner's devisees or heirs. Cal. Corp. Code §15025(2)(d) (West Supp. 1984).The Tax Court minority concluded from these differences that the transformation of the Magnesons' tenancy in common into a partnership interest "so changed their legal relationship to that property as to disqualify the exchange from section 1031(a) treatment." We disagree. While there are significant distinctions, we do not believe that they are controlling in determining the holding for investment issue. First, we note that the crucial question in a

section 1031(a) analysis is continuity of investment in like-kind property. Therefore, the critical attributes in the taxpayer's relationship to the property are those relevant to holding the property for investment. As both tenants in common and as general partners, the Magnesons owned an interest in the Plaza Property. As both tenants in common and as general partners, the Magnesons had the right to possess and control the property. While it is true that section 15025(2)(a) limits their possession and control to partnership purposes, the partnership purpose was to hold for investment. Under these circumstances their control as general partners is of the same nature as their control as tenants in common, in each case holding the property for investment.The significant differences between the tenancy in common and the partnership interests lie in the voluntary and involuntary alienability of the property. Basically, the tenancy in common interest is freely alienable, but specific partnership property is not. Because the whole premise of section 1031(a) is that the taxpayer's intent is *not to alienate* the property, we believe that alienability distinctions are not dispositive. If at the time of the exchange, as here, the taxpayer intends to contribute the property to a partnership for a general partnership interest, and the partnership's purpose is to hold the property for investment, the holding requirement of section 1031(a) is satisfied despite the limited alienability of specific partnership property.The Commissioner contends that the Tax Court majority, in focusing exclusively on the continuity of investment principle underlying section 1031(a), ignored the equally important technical requirements of the section itself. Treasury Regulation 1.1002-1(b) provides:

The exceptions from the general rule requiring the recognition of all gains and losses ... are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule.

The Commissioner contends that this double test applies, and that even if this transaction satisfies the "underlying purpose" prong of the test, it still fails to qualify under the "specific description" prong because technically the partnership and not the taxpayers holds the acquired property. This circuit, however, rejected an analogous argument in Starker, 602 F.2d at 1352-53, refusing to give such a narrow construction. The Commissioner argued in Starker that the language of the regulation quoted above, as applied to section 1031(a), required simultaneous transfer for section 1031(a) nonrecognition. After analyzing the legislative history of section 1031(a) and concluding that it did not support the Commissioner's position, the court stated:

[T]here is a second sound reason to question the applicability of Treas. Regs. §1.1002-1: the long line of cases liberally [pg. 85-916] construing section 1031. If the regulation purports to read into section 1031 a complex web of formal and substantive requirements, precedent indicates decisively that the regulation has been rejected.

Starker, 602 F.2d at 1352; see, e.g., Coastal Terminals, Inc. v. United States, 320 F.2d 333, 336-39 [12 AFTR2d 5247] (4th Cir. 1963) (cash option did not preclude section 1031(a) nonrecognition because taxpayer intended to take cash only if no property available); Alderson v. Commissioner, 317 F.2d 790, 793 [11 AFTR2d 1529] (9th Cir. 1963) (three-corner exchange); Biggs, 69 T.C. at 913-14 (four-corner exchange); 124 Front Street, Inc. v. Commissioner, 65 T.C. 6, 17-18 (1975) (taxpayer can advance money toward purchase price of property to be acquired); Coupe v. Commissioner, 52 T.C. 394, 405-09 (1969) (taxpayer can locate and negotiate for the property to be acquired); J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608, 611 (1962) (taxpayer can oversee improvements on the land to be acquired). Applying the Starker manner of construing the section, we decline to read into section 1031(a) the requirement that the taxpayer continue to hold the acquired property by the exact form of ownership in which it was acquired. So long as, as in this case, the taxpayers continue to own the property and to hold it for investment, a change in the mechanism of ownership which does not significantly affect the amount of control or the nature of the underlying investment does not preclude nonrecognition under section 1031(a).

(II.) The Step Transaction Doctrine As an alternate position, the Commissioner contends that the step transaction doctrine should be applied in this case and would preclude section 1031(a) nonrecognition. Under this doctrine, the court must view the transaction as a whole even if the taxpayer uses a number of steps to consummate the transaction. See Commissioner v. Court Holding Co., 324 U.S. 331, 334 [33 AFTR 593] (1945). A taxpayer may not secure, by a series of contrived steps, different tax treatment than if he had carried out the transaction directly. Crenshaw v. United States, 450 F.2d 472, 475-78 [28 AFTR2d 71-5846] (5th Cir. 1971), cert. denied, 408 U.S. 923 (1972). Viewed as a whole, the Commissioner argues that the Magnesons have exchanged their fee interest in the Iowa Street Property for a partnership interest in U.S. Trust, which the Commissioner contends is not like-kind property under this court's decision in Meyer, 503 F.2d at 557-58 (general and limited partnership interests not like-kind).Initially, we note that it may not be appropriate to collapse the steps of this transaction, because it is not readily apparent that the transaction could have been achieved directly. The Magnesons started out with the Iowa Street Property, which was worth one tenth of the Plaza Property. NER owned 100% of the Plaza Property. NER and the Magnesons wanted to end up owning the Plaza Property together in a partnership, and the Magnesons wanted to pay for their share with the Iowa Street Property. The Magnesons could have sold the Iowa Street Property, used the proceeds to buy ten percent of the Plaza Property, and then formed the partnership with NER, but that would have added a step to the transaction, rather than being a more direct route than that taken. Alternatively, NER and the Magnesons could have formed the partnership with the Iowa Street Property and ninety percent of the Plaza Property, and then the partnership could have exchanged the Iowa Street Property for the remaining ten percent of the Plaza Property. Again, this is no more direct than the method by which the Magnesons chose to carry out the transaction. Between two equally direct ways of achieving the same result, the Magnesons were free to choose the method which entailed the most tax advantages to them. Biggs, 69 T.C. at 913 (quoted in Starker, 602 F.2d at 1353 n.10).Even if we apply the step transaction doctrine, and view the transaction as an exchange of the Magnesons' fee interest in the Iowa Street Property for a partnership interest in the Plaza Property, we believe that the transaction qualifies under section 1031(a). [4] The Commissioner argues that this case is controlled by Meyer, which held that a general partnership interest and a limited partnership interest were not like-kind although the underlying property in each partnership was like-kind. Meyer, 503 F.2d at 558. Meyer based its holding on the significant differences between general and limited partnership interests. A general partner has "a broad spectrum of rights and liabilities," id. at 557, including, importantly, [pg. 85-917] general liability and rights to management and control. A limited partner's rights are restricted to certain inspection and accounting rights, and the power to dissolve the partnership under certain circumstances. Cal. Corp. Code §§15507, 15510, 15515-15517. A limited partner may not actively participate in running the business. He is "primarily an investor, dependent upon the efforts of others to make a profit," and has limited liabilities. Meyer, 503 F.2d at 558. Thus Meyer is based on the change in the taxpayer's ability to manage and control the property.Meyer is not controlling in this case because, as discussed above, the rights of a fee owner and of a general partner to management and control are very similar.

Rather than losing any participation in operating the investment property, as did the taxpayer in Meyer, the Magnesons as general partners are the managers of their investment, just as they were when they owned the Iowa Street Property in fee simple. Thus, we reject the Commissioner's argument that application of the step transaction doctrine disqualifies this exchange for section 1031(a) nonrecognition.Finally, we note that a critical basis for our decision is that the partnership in this case had as its underlying assets property of like kind to the Magnesons' original property, and its purpose was to hold that property for investment. Recent Tax Court cases considering the exchange of one partnership interest for another have looked to the underlying assets of the partnerships and required not only that the partnership interests be of like kind, e.g., general for general, or general for joint venture, but that the underlying assets be of like kind. See Pappas, 78 T.C. at 1087; Gulfstream, 71 T.C. at 594-96. The purpose of this scrutiny is to prevent taxpayers from creating partnerships to hold assets that are not of like kind, and then exchanging the seemingly like-kind partnership interests. In such a case, the partnership form is being used artificially to shield from recognition an exchange that otherwise would not qualify under section 1031(a), Gulfstream, 71 T.C. at 595, and the Tax Court properly prescribed scrutiny of the underlying assets to prevent such abuse. In the Magnesons' situation, whether we view the transaction as an exchange followed by a contribution, or as an exchange of real estate for a partnership interest, we will examine the purpose and underlying assets of the partnership acquired to determine if the Magnesons have a continuing investment in like-kind property. The property the Magnesons contributed to the partnership was, of course, of like kind to their original property. The rest of the partnership property was also like-kind, and the partnership's purpose was to hold real estate investment property, the kind of property that the Magnesons initially owned. Therefore, the Magnesons' ten-percent partnership interest in the underlying assets was entirely in like-kind property to their original investment, and the transaction qualifies under section 1031(a). In contrast, if the Magnesons had made the same initial exchange for like-kind real estate, but had contributed the real estate to a partnership that did not hold it for investment, or that did not have as the predominant part of its assets other like-kind real estate, the exchange would not qualify under section 1031(a). This would be so because once the Magnesons contributed their property, the underlying assets of their investment are the other assets of the partnership, and if those assets are not of like kind to the Magnesons' original real estate investment, the Magnesons have not continued their investment in like-kind property.Our holding in this case is limited to those situations in which the taxpayer exchanges property for like-kind property with the intent of contributing the acquired property to a partnership for a general partnership interest. Further, the taxpayer must show, as the Magnesons have here, that the purpose of the partnership is to hold the property for investment, and that the total assets of the partnership are predominantly of like kind to the taxpayer's original investment. Affirmed.

*

Honorable William J. Jameson, Senior United States District Judge for the District of Montana, sitting by designation.

1

All references to sections, unless otherwise indicated, are to the Internal Revenue Code of 1954 as amended and applicable in the tax year 1977.

2

Section 351 provides, in pertinent part:
(a) General rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

3

The full text of Treas. Reg. 1.1002-1 is as follows:

((a)) General rule. The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Code provide otherwise.

((b)) Strict construction of exceptions from general rule. The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

((c)) Certain exceptions to general rule. Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

This section of the regulations was subsequently changed due to incorporation of section 1002 into section 1001 as section 1001(c), but was applicable to the taxable year 1977, which is before the court in this case. See T.D. 7665, 1980-1 C.B. 319.

4

We note that for transactions executed after July 18, 1984, Congress has amended section 1031(a) to exclude the exchange of partnership interests. Deficit Reduction Act of 1984, Pub. L. No. 98-367, §77, 98 Stat. 494, 595; see H.R. Rep. No. 432, 98th Cong., 2d Sess. 1231-34, reprinted in 6B 1984 U.S. Code Cong. & Ad. News 1, 201-04 (revision aimed primarily at forbidding tax-free exchange of "burned-out" tax shelter partnership interests).

BONNY B. MALONEY AND ROBERT S. MALONEY V. COMMISSIONER, 93 T.C. 89

Case Information: [pg. 89]
Code Sec(s): 1031
Docket: Docket Nos. 41612-84, 1716-85.
Date Issued: 07/25/1989
Judge: Opinion by CHABOT, *J.*
Tax Year(s): Years 1978, 1979.
Disposition: Decision for Taxpayers.

Counsel

John A. Stassi, II, and June Y. Bass, for the petitioners in docket No. 41612-84.

Charles B. Johnson, for the petitioners in docket No. 1716-85.

Deborah R. Jaffe, for the respondent.

Chabot, *Judge:*

Respondent determined deficiencies in Federal individual income tax and additions to tax under [pg. 90]section 6653(a) [1] (negligence, etc.) against petitioners (in docket No. 41612-84) as follows:

		Additions to tax
Taxable year	Deficiency	sec. 6653(a)
1978	$39,977	$1,998.85
1979	321,883	16,094.15

Respondent also determined that each petitioner (in docket No. 1716-85) is liable as a transferee of the assets of Maloney Van & Furniture Storage, Inc. (hereinafter sometimes referred to as Van) for a deficiency in Federal corporate income tax for 1978 in the amount of $115,418.03. These cases have been consolidated for trial, briefs, and opinion. After concessions by both sides in docket No. 41612-84, the issue for decision that controls both dockets is whether a particular exchange of real estate qualifies for nonrecognition under section 1031. [2]

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petitions were filed in the instant cases, petitioners Bonny B. Maloney, and Robert S. Maloney (hereinafter sometimes referred to as Maloney), wife and husband, resided in New Orleans, Louisiana.

Van, a Louisiana corporation, was a calendar year taxpayer. Van was formed in 1966, and its initial business activity, as its name suggests, was the moving and storing of furniture. Sometime in 1977, Van discontinued the active conduct of that business; thereafter, its only activity until its dissolution was the leasing of its assets to related corporations. From the time Van was formed until December 12, 1978, petitioners owned 80 percent of Van's stock and Olga Maloney (hereinafter sometimes referred to as Olga) owned the remaining 20 percent. Olga was Maloney's stepmother. Maloney's father died in 1978. On December [pg. 91]12, 1978, Maloney acquired the remaining 20 percent of the stock in Van from Olga in exchange for his $125,000 nonnegotiable, noninterest-bearing promissory note. The note was payable in installments over 20 years, beginning January 1, 1984. From then until Van's dissolution, petitioners owned all of Van's stock.

Maloney also had an interest in a number of other corporations, including Maloney Trucking & Storage, Inc., and Gallagher Transfer & Storage (hereinafter sometimes collectively referred to as the Maloney interests).

One of Van's primary assets was a piece of real estate (hereinafter sometimes referred to as the I-10 property) located in Jefferson Parish, in or near Metairie, near Cleary Avenue, and extending to the I-10 service road. This is northwest of downtown New Orleans, just outside the New Orleans city limits. Van bought the I- 10 property on or about August 15, 1971. At the same time, Van bought land adjoining the I-10 property on the western side. Van's intention at that time was to build a warehouse on this adjoining property and to hold the I-10 property for investment or development. Van built the warehouse on this adjoining property and held the I-10 property for investment.

In mid-1978, Maloney indicated to his attorney, Charles B. Johnson (hereinafter sometimes referred to as Johnson), that there was a possible purchaser for the I-10 property. Maloney also mentioned to Johnson that the Maloney interests were considering acquiring a piece of property on Elysian Fields Avenue in New Orleans (that property is hereinafter sometimes referred to as Elysian Fields). Elysian Fields is northeast of downtown New Orleans. Johnson advised Maloney that a like-kind exchange would produce more favorable tax results than a taxable sale or exchange. As of August 2, 1978, Maloney intended to consolidate the different businesses with which he was associated. He also intended that operations of the Maloney interests be located on Elysian Fields. Neither Van nor Maloney intended to sell Elysian Fields.

On August 2, 1978, Van entered into an exchange agreement (hereinafter sometimes referred to as the exchange agreement") with James Goldsmith and Edward [pg. 92]Hernandez (hereinafter sometimes collectively referred to as Goldsmith and Hernandez). Under the exchange agreement, Van agreed to transfer the I-10 property to Goldsmith and Hernandez. In exchange, Goldsmith and Hernandez were to convey to Van property referred to in the exchange agreement as "the exchange property", which was intended to be Elysian Fields. The I-10 property and Elysian Fields are properties of a like kind.

The exchange described in the exchange agreement was subject to several conditions. Firstly, Goldsmith and Hernandez did not yet own Elysian Fields, so they were to enter into an agreement to buy Elysian Fields under terms acceptable to Van. Secondly, Goldsmith and Hernandez would have to obtain valid and merchantable title to Elysian Fields, and Van would have to provide valid and merchantable title to the I-10 property. If Goldsmith and Hernandez were unable to acquire valid and merchantable title to Elysian Fields (first condition, above) or were unable to enter into an agreement to purchase Elysian Fields on terms acceptable to Van, then Van would nevertheless be obligated to sell the I-10 property to Goldsmith and Hernandez for cash. Thirdly, the exchange was conditioned on Goldsmith and Hernandez' obtaining a zoning change on the property adjacent to the I-10 property.[3]

On October 15, 1978, Goldsmith and Hernandez entered into an agreement to buy Elysian Fields from Robert Coffin (hereinafter sometimes referred to as Coffin). Coffin did not at that time own Elysian Fields; on August 8, 1978, Coffin had entered into an agreement to buy Elysian Fields from Hibernia National Bank in New Orleans (hereinafter sometimes referred to as Hibernia). The agreement between Coffin and Hibernia was conditioned on certain zoning changes being made. On October 12, 1978, the Council of the City of New Orleans approved the rezoning upon which the agreement between Coffin and Hibernia was conditioned. The Comprehensive Zoning Ordinance of the City of New Orleans was amended accordingly on April 19, 1979. On November 29, 1978, the Jefferson Parish Council approved [pg. 93]the rezoning of the property adjacent to the I-10 property, as contemplated in the exchange agreement; the rezoning became effective on December 11, 1978.

In early December, Maloney advised Johnson that there was a possible purchaser for the property adjoining the I-10 property on its western side. Johnson began to consider the possibility of liquidating Van. Shortly thereafter, Johnson and Maloney discussed the possibility of liquidating Van. Maloney reacted favorably. Johnson recommended that Maloney take certain steps before liquidating Van. Firstly, Johnson recommended that Maloney acquire Olga's Van stock. Maloney bought Olga's Van stock on December 12, 1978, as discussed *supra.* Secondly, Johnson recommended that Maloney contribute additional capital to Van. On December 28, 1978, Maloney borrowed $400,000 and contributed it to Van. The cash so contributed was used in part to provide the $374,112 that Van was to pay to Goldsmith and Hernandez on the exchange.

Maloney made his decision to liquidate Van in mid-December of 1978, within a few days of his discussions with Johnson.

On December 28, 1978, the following also occurred: (1) Hibernia transferred Elysian Fields to Coffin; (2) Coffin transferred Elysian Fields to Goldsmith and Hernandez; and (3) Goldsmith and Hernandez transferred Elysian Fields to Van, and in return Van transferred the I-10 property plus $374,112 in cash to Goldsmith and Hernandez.

Van realized gain on the exchange in the amount of $371,144.57.[4]

Soon after Van acquired Elysian Fields, a local funeral home sought to buy Elysian Fields from Van, but Van would not sell the property.

On January 2, 1979, Van's directors (i.e., petitioners and Olga) adopted a plan to liquidate Van under section 333, and on January 3, 1979, Van's shareholders (i.e., petitioners) approved that plan. As of January 26, 1979, Van was completely liquidated in full compliance with the requirements of section 333, and on that date, all of Van's assets were distributed to petitioners. The fair market values of [pg. 94]the assets transferred from Van to petitioners on Van's liquidation were as shown in Table 1.

Table 1

Asset	Amount
Land-Elysian Fields	$900,000.00
Land-Metairie	200,084.00
Building-Metairie	137,416.00
Accounts receivable	91.90
Cash	2,219.97
Total	1,239,811.87

The aggregate value of these assets exceeded Van's income tax liability as determined in the notices of transferee liability issued to petitioners.

On Van's liquidation, petitioners assumed Van's liabilities in the amount of $228,347.15. Petitioners' basis in their Van stock as of the time of Van's liquidation was $529,000.

As previously stated, Van realized gain on the exchange in the amount of $371,144.57. Petitioners realized gain on the liquidation in the amount of $482,464.72, computed as follows:

Property received	$1,239,811.87
Less: liabilities assumed	-228,347.15
Balance	1,011,464.72
Less: basis in stock	-529,000.00
Realized gain	482,464.72

After petitioners acquired Elysian Fields, they leased it to Gallagher Transfer & Storage for a term of about 25 or 30 years. Gallagher Transfer & Storage constructed a building on Elysian Fields and uses about 60 percent of the land for its own purposes and subleases about 40 percent to others for parking of cars and trucks. At the end of the lease term, the building constructed by Gallagher Transfer & Storage is to revert to petitioners.

When Van received Elysian Fields in exchange for the I-10 property and cash, it was intended that Van liquidate and distribute Elysian Fields to petitioners and that Elysian Fields be held for investment. It was not intended that [pg. 95]Elysian Fields be sold, or used for personal purposes, or transferred by way of gift.

OPINION

Respondent contends that the exchange of the I-10 property for Elysian Fields does not qualify for nonrecognition under section 1031(a) because Van did not hold Elysian Fields for productive use in trade or business or for investment; rather, Van intended to distribute Elysian Fields to its shareholders (petitioners) under section 333.[5] Respondent concedes that, if Van had not been liquidated but everything else (including the later use of Elysian Fields) had taken place as it did, then the exchange would have resulted in nonrecognition of gain under section 1031(a).
Petitioners maintain that an intent to liquidate under section 333 does not necessarily cause a transaction to fail the "holding" requirement of section 1031. They contend that they did not intend to cash out their investment in the property received, and that they therefore qualify for nonrecognition under section 1031.

We agree with petitioners that the exchange qualifies under section 1031.

If (a) Elysian Fields and the I-10 property are of like kind, (b) before the exchange Van held the I-10 property for investment, and (c) after the exchange Van held Elysian Fields for investment, then under section 1031(a)[6] Van does [pg. 96]not recognize any gain on its exchange of the I-10 property for Elysian Fields.[7]

The purpose of section 1031 (and its predecessors) is to defer recognition of gain or loss on transactions in which, although in theory the taxpayer may have realized a gain or loss, the taxpayer's economic situation is in substance the same after, as it was before, the transaction. Stated otherwise, if the taxpayer's money continues to be invested in the same kind of property, gain or loss should not be recognized. H. Rept. 73-704 (to accompany H.R. 7835, the Revenue Act of 1934) p. 13 (1934), 1939-1 C.B. (Part 2) 554, 564; *Biggs v. Commissioner,* 69 T.C. 905, 913 (1978), affd. 632 F.2d 1171 (5th Cir. 1980).

Section 333[8] recognizes a taxpayer's continuing investment in the property received (here, real estate), without the interposition of a corporate form. *Bolker v. Commissioner,*[pg. 97] 81 T.C. 782, 805 (1983), affd. 760 F.2d 1039 (9th Cir. 1985). The taxpayer's basis in the property received in a section 333 liquidation is equal to the basis in the stock surrendered, and the gain is not recognized, but is deferred until the investment is cashed out. At that point, the gain is taxed.*Id.*

In *Magneson v. Commissioner,* 81 T.C. 767 (1983), affd. 753 F.2d 1490 (9th Cir. 1985), the taxpayers exchanged property A for like-kind property B, after which the taxpayers contributed property B to a limited partnership. The contribution of property B was nontaxable under section 721. We held that the contribution of property B to the partnership was not a liquidation of the taxpayers' investment, but rather was a continuation of the old investment unliquidated in a modified form. 81 T.C. at 771.

In passing, we note that the term "liquidation" is often used in this context as equivalent to a disposition that "cashes out" the investment. This is the sense that is described as follows in H. Rept. 73-704 (to accompany H.R. 7835, the Revenue Act of 1934) p. 13 (1934), 1939-1 C.B. (Part 2) 554, 564:

The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind [as the property disposed of] having a fair market value.

This is different from "liquidation" under section 333, where the corporation's shareholders are to receive the exchanged-for property, and not cash. Thus, in *Regals Realty Co. v. Commissioner,* 43 B.T.A. 194 (1940), affd. 127 F.2d 931 (2nd Cir. 1942), discussed *infra,* the first holding that section 1031 did not apply was based on the taxpayer's intent to liquidate, in the sense of selling the property for cash, and not based on their intent to liquidate the corporation. In *Bolker v. Commissioner,* 81 T.C. 782 (1983), affd. 760 F.2d 1039 (9th Cir. 1985), the corporation was liquidated, but the property was received in kind by the taxpayer; there we held that section 1031 granted nonrecognition.

In *Bolker v. Commissioner, supra,* we dealt with the interplay of sections 1031 and 333. There, the taxpayer caused his corporation to liquidate under section 333; he [pg. 98]then transferred to an unrelated person the property he received in the liquidation, in exchange for property of like kind, and claimed that the exchange was tax-free under section 1031. We concluded, in effect, that the taxpayer is treated as having had the same purpose for holding the property as the taxpayer's corporation had before the section 333 liquidation, as follows (81 T.C. at 805-806):

We believe *Magneson* entitles petitioner to relief herein. In both *Magneson* and the instant case, property A was exchanged for property B in a like-kind exchange, both properties being held for business or investment as opposed to personal purposes. In*Magneson,* the exchange of A for B was immediately followed by a tax-free section 721 transfer; in the instant case, the exchange of A for B was immediately preceded by a tax-free acquisition under section 333. That the tax-free transaction preceded rather than followed the exchange is insufficient to produce opposite results. For, as noted, section 1031's holding for business or investment requirement is reciprocal, equally applicable to properties at both ends of an exchange. Nothing in the policy underlying section 1031 suggests that this minor variation in sequence warrants treating taxpayers dramatically different.

Even aside from *Magneson,* we believe petitioner is correct. A trade of property A for property B, both of like kind, may be preceded by a tax-free acquisition of property A at the front end, or succeeded by a tax-free transfer of property B at the back end. Considering first the tax-free acquisition of property A through a section 333 liquidation at the front end, it is appropriate to ask why gain is deferred on a liquidation. In short, where a

taxpayer surrenders stock in his corporation for real estate owned by the corporation, he continues to have an economic interest in essentially the same investment, although there has been a change in the form of ownership. His basis in the real estate acquired on liquidation is equal to his basis in the stock surrendered, and the gain realized is not recognized but deferred until gain on the continuing investment is realized through a liquidating distribution. At that point, proceeds of the sale are taxed to the extent of the gain.

Section 333 recognizes the taxpayer's continuing investment in the real estate without the interposition of a corporate form. If property A is traded for like-kind property B for business or investment purposes, the taxpayer has not cashed out his venture, and gain or loss should not be recognized. Section 1031 is designed to apply to these circumstances and to defer recognition of gain or loss where the "taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."*Jordan Marsh Co. v. Commissioner,* 269 F.2d 453, 456 (2d Cir. 1959), revg. a Memorandum Opinion of this Court, quoting *Portland Oil Co. v. Commissioner,* 109 F.2d 479, 488 (1st Cir. 1940). Accordingly, we hold that the exchange of the Montebello property qualifies for nonrecognition treatment under section 1031.[pg. 99]

The instant cases may be viewed as a variant of *Magneson* (exchange of like-kind properties followed by a tax-free change in form of ownership) or as a variant of *Bolker* (interplay of sections 333 and 1031). In either view, petitioners have satisfied the requirements of section 1031.

Van's purpose was the purpose of petitioners, Van's owners. The acquired property, Elysian Fields, was not liquidated in the sense of being cashed out (as in *Regals Realty Co. v. Commissioner,* 43 B.T.A. 194 (1940), affd. 127 F.2d 931 (2nd 1942)); it was not transferred as a gift (as were the residences in *Click v. Commissioner,* 78 T.C. 225 (1982)). Rather, Elysian Fields continued to be held for investment by Van's owners.

The exchange before us reflects both continuity of ownership and of investment intent. Before the exchange, Van owned the I-10 property. After the exchange, Van owned Elysian Fields. Both before and after the exchange, petitioners owned all of Van's stock. After the section 333 liquidation, petitioners owned Elysian Fields directly, without the interposition of the corporate form. Petitioners continued to have an economic interest in essentially the same investment, although there was a change in the form of ownership. *Bolker v. Commissioner,* 81 T.C. at 805. Petitioners at all relevant times intended to continue to use Elysian Fields for investment. Petitioners had Van enter into the exchange because petitioners intended to operate some of their other businesses on Elysian Fields.

If Van had not been liquidated and had used Elysian Fields precisely as its shareholders did, then clearly the exchange would have been nontaxable under section 1031; so respondent concedes. As we understand*Magneson* and *Bolker,* the mere addition of another nontaxable transaction (at least, a transaction exempted by section 721 or 333) does not automatically destroy the nontaxable status of the transaction under section 1031.

On the authority of *Magneson* and *Bolker,* we conclude that Van's exchange of the I-10 property plus cash, in return for Elysian Fields, is tax-free as to Van under section 1031.

On brief, respondent states that "the evidence in [the instant cases] establishes that Van, an inactive corporation, [pg. 100]did not initiate any attempts to acquire the Elysian Fields property, and was not going to use the Elysian Fields property in a trade or business." If we were to accept this view of the situation, and if Van had liquidated before the exchange, then the instant cases would be on all fours with*Bolker.* It seems, given respondent's view of the facts, that respondent's basic quarrel with what was done in the instant cases is solely as to the order in which the exchange and the liquidation took place. We have already stated plainly our position on that point in *Bolker v. Commissioner,* 81 T.C. at 805, set forth *supra.* Thus, respondent's analysis merely strengthens petitioners' position in the instant cases.

Respondent states as his view that "the intent to liquidate and to distribute property to shareholders is akin to an intent to sell the property or to gift it." We disagree. This has already been decided adversely to respondent. *Bolker v. Commissioner, supra.*

On brief, respondent directs our attention to the Court of Appeals' opinion in *Bolker v. Commissioner,* 760 F.2d at 1045, in which that court states that "a taxpayer may satisfy *** the 'for productive use in trade or business or for investment' requirement by lack of intent either to liquidate the investment or to use it for personal pursuits." Respondent then states as follows:

At the time of the exchange, Van intended to liquidate and upon liquidation to distribute all of its property, including the property received in the exchange to its shareholders. Van would then cease to exist. It is incomprehensible that such an intent could be viewed as not being an intent to liquidate its investment. Liquidating its investment is in fact clearly what Van intended to do, and did do.

Respondent appears to have confused two senses of "liquidate". Van did not intend to liquidate Elysian Fields in the sense of receiving for it "cash, marketable securities, or other property not of the same kind having a fair market value." See discussion of this point, *supra;* see also*Zuanich v. Commissioner,* 77 T.C. 428, 443 n. 26 (1981), regarding "utraquistic subterfuge". The section 333 liquidation was held not to be a cashing out liquidation in *Bolker,* and we conclude that it is not a cashing out liquidation in the instant cases.[pg. 101]

Respondent cites *Regals Realty Co. v. Commissioner,* 43 B.T.A. at 211, as support for his contention that section 1031 does not allow the property received to be liquidated to the recipient-corporation's shareholder.

In *Regals Realty,* shortly after the exchange there in issue, the taxpayer decided "to liquidate *** promptly, and in connection therewith *to sell the real estate which had just been received and to distribute the proceeds of that sale* to complete the liquidation." 43 B.T.A. at 209, emphasis supplied. For one or more reasons, the property was not sold for cash. Instead, in the next year, the property was contributed to a newly-formed corporation in exchange for the newly-formed corporation's stock, and that stock was distributed to the taxpayer's shareholders in the taxpayer's liquidation 43 B.T.A. 204-205. We held that, at the time of the exchange, the taxpayer intended to sell the received property for cash and not to hold the property "for productive use in trade or business or for investment", as the statute requires. Accordingly, we held that the exchange was not tax-free and the taxpayer would have to recognize its gain. 43 B.T.A. at 209-210. See also *Regals Realty Co. v. Commissioner,* 127 F.2d at 933-934.

After so holding, the Board added the following (43 B.T.A. at 210-211):

Petitioner contends further that the intention should be gauged by what was actually done rather than by the expression of that intent. We are not persuaded that this is correct. But, assuming we were to do so, the result would be the same. For the action actually taken was to dispose of the property to another corporation controlled by the same interests. It may be true that this transaction was in the nature of a tax-free reorganization. Nevertheless it was a transfer from this petitioner and made it impossible for it to "hold" the property as an investment. We think the provisions of 112(b)(1) [the predecessor of sec. 1031] were intended to apply only to the same taxpayer. We are not required to disregard the separate corporate entities of petitioner and its successor at the behest of their creators. *Higgins v. Smith,* 308 U.S. 473 [1940].

This alternative holding was relied on in *Vim Securities Corp. v. Commissioner,* 43 B.T.A. 759, 769 (1941), affd. 130 F.2d 106 (2nd Cir. 1942), which involved nonrecognition under section 112(f) of the Revenue Act of 1936 (the predecessor of section 1033), and which accordingly is not[pg. 102] dispositive of the instant cases. This point is explained in *Magneson v. Commissioner,* 81 T.C. at 772. The alternative holding of *Regals Realty* was distinguished in *United States v. Brager Building & Land Corp.,* 124 F.2d 349, 351 (4th Cir. 1941). The Circuit Court of Appeals for the Second Circuit affirmed the Board in*Regals Realty* without mention of this alternative holding. Although we have relied on the basic holding of *Regals Realty* in a number of cases, e.g., *Bolker v. Commissioner,* 81 T.C. at 805;*Magneson v. Commissioner,* 81 T.C. at 781 (1983);*Click v. Commissioner,* 78 T.C. at 231; *Wagensen v. Commissioner,* 74 T.C. at 659, we have not found any case involving sections 333 and 1031 which has relied on, or even mentioned the alternative holding of *Regals Realty.*

We need not decide in the instant cases whether we agree with the*Regals Realty* alternative holding that a section 351 transaction would be incompatible with a section 1031 tax-free exchange. Compare*Magneson v. Commissioner,* 81 T.C. at 773 n .5, with*Magneson v. Commissioner,* 753 F.2d at 1493. We have already held that section 721 and section 333 transactions are not incompatible with section 1031 tax-free exchanges.

We conclude that (1) *Regals Realty*'s basic holding is consistent with our holding in the instant cases, and (2) *Regals Realty*'s alternative holding is distinguishable.

Respondent also contends that, from petitioners' perspective, the exchange, in substance, constitutes an exchange of stock for property, which is expressly excluded from the nonrecognition provisions of section 1031(a). The exchange in issue was between Van, on the one hand, and Goldsmith and Hernandez, on the other. Van received only real estate in the exchange. (Van paid $374,112 to Goldsmith and Hernandez, which is boot, and presumably taxable to Goldsmith and Hernandez under section 1031(b); however, Goldsmith and Hernandez are not before us.) Even if petitioners transferred stock to Van in the course of the section 333 liquidation, the like-kind exchange was, from Van's (as well as from petitioners') viewpoint, both in form and in substance, an exchange of real estate.

We hold for petitioners. As a result, (1) Van does not have an income tax deficiency and so petitioners do not [pg. 103]have a transferee liability, and (2) Van does not have increased earnings and profits and so petitioners do not have to recognize increased gain on Van's liquidation.
To reflect petitioners' concessions in docket No. 41612-84,

Decision will be entered under Rule 155 in docket No. 41612-84, and decision will be entered for the petitioners in docket No. 1716-85.

[1]

Unless indicated otherwise, all section references are to sections of the Internal Revenue Code of 1954, as in effect for the years in issue.

[2]

In docket No. 41612-84, the adjustments to medical expense deductions are derivative, and depend on the settled issues and on our determination as to the sec. 1031 issue; petitioners have conceded negligence for 1978 and respondent has conceded it for 1979.

[3]

The exchange agreement provided a requirement for rezoning of the I-10 property. About 2 months later, the exchange agreement was amended to replace that requirement with a requirement for rezoning of certain property immediately to the east of the I-10 property.

[4]

The notices of transferee liability show the gain as $371,144.07. The notice of deficiency shows the gain as $371,144. Our finding is in accordance with the parties' stipulation.

[5]

The parties agree that if we decide that the exchange did not qualify under sec. 1031, then: (1) Van has additional income for 1978 in the amount of $371,144.57 (see n. 4, *supra* and accompanying text), and a deficiency in Federal corporate income tax in the amount of $115,418.03; (2) petitioners, as transferees of Van's assets (within the meaning of sec. 6901(a)(1)(A)) are liable for Van's entire deficiency as determined in the notices of transferee liability; (3) Van has additional earnings and profits as of Jan. 26, 1979, in the amount of $371,144.57; and (4) under sec. 333(e), petitioners' recognized gain on Van's liquidation is increased by the amount of $371,144.57.

In order for property to qualify for like-kind exchange treatment, the property must be held either for productive use in trade or business or for investment. However, business property may be exchanged for investment property and vice versa. Sec. 1031(a), sec. 1.1031(a)-1(a), Income Tax Regs. Accordingly, the distinction between "trade or business" and "investment" is immaterial for our purposes; for convenience, we will use the term "held for investment".

6

§1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT.

(a) Nonrecognition of Gain or Loss From Exchanges Solely in Kind.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

[The subsequent amendments of this provision by sec. 77 of the Deficit Reduction Act of 1984 (Pub. L. 98-369, 98 Stat. 494, 595) and by sec. 1805(d) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085, 2810) do not apply to the instant cases. The provision now appears as paragraphs (1) and (2) of sec. 1031(a).]

7

If cash or other property which does not qualify as like-kind property is included in the exchange, then gain is recognized to the extent of the cash or other property received. Sec. 1031(b); *Wagensen v. Commissioner,* 74 T.C. 653, 657 (1980). In the instant cases, Van paid cash but did not receive cash, and the parties agree that Elysian Fields and the I-10 property are of like kind.

8

Sec. 333 provides, in pertinent part, as follows:

SEC. 333. ELECTION AS TO RECOGNITION OF GAIN IN CERTAIN LIQUIDATIONS.

(a) General Rule.—In the case of property distributed in complete liquidation of a domestic corporation *** , if—

(1) the liquidation is made in pursuance of a plan of liquidation adopted, and

(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month,

then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f). ***

(e) Noncorporate Shareholders.—In the case of a qualified electing shareholder other than a corporation—

(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; ***

[The subsequent repeal of sec. 333 by sec. 631(e)(3) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2273, does not affect the instant cases.]

REGALS REALTY CO. V. COMMISSIONER OF INTERNAL REVENUE, CITE AS 29 AFTR 444 (127 F.2D 931)

Case Information:

Code Sec(s):	
Court Name:	U.S. Court of Appeals, Second Circuit.
Docket No.:	No. 163.
Date Argued:	04/09/1942
Date Decided:	05/08/1942
Disposition:	
Cites:	29 AFTR 444, 127 F2d 931, 42-1 USTC P 9468.

OPINION

Chadbourne, Hunt, Jaeckel & Brown, of New York City (Richard P. Jackson, of New York City, of counsel), for petitioner.

Samuel O. Clark, Jr., Asst. Atty. Gen., and Sewall Key, Gerald L. Wallace, and Arthur A. Armstrong, Sp. Assts. to the Atty. Gen., for respondent.

Appeal from a decision of the Board of Tax Appeals.

Petition by the Regals Realty Company, opposed by the Commissioner of Internal Revenue, to review a decision of the Board of Tax Appeals, 43 B.T.A. 194, finding deficiencies of $61,142.44 in income tax and $26,257.21 in excess profits tax for the year 1936.

Affirmed.

Before L. HAND, SWAN, and FRANK, Circuit Judges.

Judge: FRANK, Circuit Judge.

This case raises the issue of whether certain Miami real estate, received upon an exchange, was "to be held *** for investment," so as to be within the tax-free exchange provisions of the Revenue Act of 1936. [1] The Board of Tax Appeals held that the exchange was taxable because the evidence "demonstrates affirmatively" that the property acquired was not "to be held" for investment. Its opinion is reported at 43 B.T.A. 194, 209.

The taxpayer was organized in 1933 by Leonard Marx, a successful real estate speculator, and two associates, to acquire, from a trustee in bankruptcy, the plot and building known as 2-10 East Flagler Street, in Miami, Florida. The price paid was $750, and the purchase was subject to existing leases, and to liens and encumbrances of more than $200,000. Marx succeeded in attracting enough new capital to make alterations and to clear up back interest and taxes, in arranging for a modification of the mortgage, and in concluding favorable leases. By the end of 1934, the property was operating at a profit. Dividends amounting to $5,000 were paid in both 1935 and 1936. In the early part of 1936, representatives of the Burdine Department Store, which was located on an adjoining plot, began negotiations with Marx for the purchase of the taxpayer's property. No definite offer was made, but Marx reported to a stockholders' meeting that he thought he could get $600,000, or about $420,000 above the mortgage. Because the tax upon such a sale would be high, the stockholders decided [pg. 446] not to consummate the proposed deal. Marx' testimony on this point was as follows:

"I explained *** that if the property was sold we would get $420,000 and under the provisions of the federal tax law we would have to pay that out as our dividends, and we would get that immediately.

"Q. Who would get that immediately? A. The stockholders, and I think out of the $420,000 we would have to pay corporate and individual taxes, and there would be $140,000 left, or something like that; maybe it was $180,000 but it was less than $200,000 anyhow. They said, 'Well, there is no sense in the deal for us. What can we buy with $140,000, or, say $150,000 that will give us anything like that income?' "

On being informed of this decision, the Burdine people made another proposal. They offered to give the taxpayer $120,000 in cash and a nearby property, located at 26 East Flagler, and worth $300,000, which they had purchased as an addition to their department but which was not suitable for that purpose because of a difference in floor levels. Under this plan, the transfer of 2-10 East Flagler was to be subject to the mortgage. In making this proposal, Burdine's representatives said that the transfer would come within the provisions of § 112(b)(1), so that only the cash received would be taxable. Mr. Marx asked his bookkeeper to look up § 112(b)(1), which "seemed to be just right." He then reported the offer to a stockholders' meeting, saying that 26 East Flagler Street had a higher traffic count than the property at 2-10, that upon the expiration in 1938 of a lease with S. H. Kress, they could probably get a higher rent for the new property, and that "I thought this was a very adequate investment, to replace the investment that we were making, and this was an excellent proposal, this swap, and I felt that they should think it over very carefully before turning it down." He said that, in his opinion, the company would be taxable only on the cash received.

The offer was accepted on July 2, 1936. On August 10, 1936, the Board of Directors met and adopted resolutions to liquidate the company, by distributing the cash received as a liquidating dividend and by selling 26 East Flagler Street. A stockholders' meeting held the same day approved of this action, adding the requirement that the liquidation should be in accordance with § 115(c) of the Revenue Act of 1936, 26 U.S.C.A. Int.Rev.Acts, page 868, which made it possible to treat dividends received on liquidation as return of capital, so that gain thus realized would be taxable at the

capital gain rate. In 1937 the taxpayer transferred its property to 26 East Flagler Street Corporation, and distributed the stock of this new corporation to its stockholders.

In arguing that the acquisition of the 26 East Flagler property by the taxpayer was a tax-free exchange under the provisions of § 112(b) quoted above, the taxpayer urges that its sole interest was in making a profitable investment. It points to the refusal to sell 2-10 as evidence of its intention not to convert its property into cash, and says that the exchange rather than a sale was decided upon so that the gain would not have to be recognized. The undisputed desire to avoid a tax on the gain, it says, is strong evidence that it did not intend to sell its property, but intended instead to hold it as an investment.

Against this we have a finding by the Board of Tax Appeals that the taxpayer did not intend to hold the property for investment. For that finding, there is ample support in the record. We have already adverted to the August 10, 1936 resolutions of the directors and stockholders, which spoke of effecting a complete liquidation of the company by selling 26 East Flagler Street. While the minutes were prepared after the meeting and by the taxpayer's counsel rather than by the Secretary, we cannot say that the Board should therefore have decided that they did not reflect accurately the events. Marx said that although the minutes used the word "sell," the intention was only to transfer the property to a new corporation. Yet, on February 10, 1937, according to the minutes of a directors' meeting, Marx "reported that in accordance with the plan of liquidation of the Company, he had been endeavoring to sell the remaining piece of real estate owned by the Company at 26 East Flagler Street, Miami, Florida. He had been unsuccessful in finding a purchaser, and he decided that apparently the time was not propitious for the sale of this property. He, therefore, suggested that, in accordance with the plan of liquidation, this property be sold to the 26 East Flagler Street Corporation, a new company in the process of formulation, in exchange for [pg. 447] One Hundred (100) shares of the capital stock of the 26 East Flagler Street Corporation."

The Board had before it other evidence in conflict with taxpayer's assertion that the property was held for investment. Thus, the day following the August 10 meeting, Marx wired a broker, in response to his inquiry about the selling-price of 26 East Flagler, that no price "has been put on building*as yet.*"[2] He repeated this statement in a letter to the same broker two weeks later.

[1-3] We need not go into the evidence in greater detail; enough has been presented to show that there was substantial evidence to sustain the Board's finding as to the taxpayer's intention, i.e., its finding that the taxpayer did not establish that 2-10 Flagler Street was exchanged for property "to be held *** for investment." We cannot grant a trial de novo merely because there was evidence on which it might have based a contrary conclusion; Helvering v. National Grocery Co., 304 U.S. 282, 294, 58 S.Ct. 932, 82 L.Ed. 1346. The Board's finding as to intention is not "a conclusion of law," as in Midwood Associates, Inc., v. Commissioner, 2 Cir., 115 F.2d 871, 872. Nor is this a case like Blackmer v. Commissioner, 2 Cir., 70 F.2d 255, 92 A.L.R. 982, where the only evidence was the taxpayer's uncontradicted testimony, which was in entire harmony with all the surrounding circumstances.

[4] The taxpayer makes a further argument, namely, that its intention at the time of the exchange is not relevant on the issue of taxability. To support this argument, it points to a statement in the Committee Report[3] on the Revenue Act of 1924 (where the forerunner of § 112(b)(1) appeared as § 203(b)(1), 26 U.S.C.A. Int.Rev.Acts, page 4) that the "intention of the party at the time of the exchange is difficult to determine, is subject to change by him and does not represent a fair basis of determining tax liability." But that statement must not be wrenched from its context. It explained the abolition, in the Act of 1924, of the earlier requirement, shown by § 202(c)(1) of the Act of 1921, 42 Stat. 230, that property held for investment must be exchanged for property to be held for investment, while property held for productive use must be exchanged for property to be held for productive use. By this requirement, it was necessary to decide whether the taxpayer's intent was to hold for investment or for productive use, and it was this examination as to intention which was rejected by Congress, which said, "If the property received is of a like kind, it is immaterial whether it is to be held for investment or for productive use." Under the amended provision, so long as the purpose is one or the other or both, the exchange is tax-free. But the taxpayer must still acquire the property (a) for investment or productive use, rather than (b) for inventory, sale, or similar purposes.

The intention to hold for a sufficient time to reduce taxes, and no longer, does not satisfy the statutory test.

The decision of the Board of Tax Appeals is affirmed.

[1] The relevant provisions are:

Revenue Act of 1936, c. 690, 49 Stat. 1648:

"§ 112. Recognition of gain or loss ***

"(b) Exchanges solely in kind—

"(1) Property held for productive use or investment. No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment. ***

"(c) Gain from exchanges not solely in kind—

"(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." 26 U.S.C.A.Int.Rev.Code, § 112 (b) (1), (c) (1).

[2] Italics added.

[3] 68th Cong., 1st sess., Sen.Rept. 398.

REVENUE RULING 77-337

Advice has been requested whether, under the circumstances described below, the exchange of property qualifies under the nonrecognition provisions of section 1031 of the Internal Revenue Code of 1954.

An individual taxpayer, A, was the sole owner of the stock of corporation X. X's only asset was a shopping center. A liquidated X pursuant to section 333 of the Code and, as a result, acquired the shopping center. Immediately following the liquidation, in a prearranged plan, A transferred the shopping center in exchange for property of a like kind owned by B, an unrelated party.

Section 333 of the Code provides, in general, that upon the liquidation of a corporation under certain specified conditions, the amount of gain recognized by a qualified electing noncorporate shareholder is computed on each share owned by the shareholder and each share's gain is limited to the greater of the share's ratable share of the corporation's earnings and profits accumulated after February 28, 1913, or the share's ratable share of the sum of the money received by the shareholder plus the fair market value of stock or securities so received that were acquired by the distributing corporation after December 31, 1953. See section 1.333-4(b) of the Income Tax Regulations. In the case of a qualified electing noncorporate shareholder, that part of the recognized gain on a share of stock that is not in excess of the ratable share of accumulated earnings and profits is taxed as a dividend and the remainder of the gain that is recognized is treated as a capital gain. Section 1.333-4(c).

Section 334(c) of the Code provides that the basis of assets (other than money) received in a liquidation to which section 333 applies shall be the same as the shareholder's basis in the stock decreased by money received and increased by gain recognized under section 333 and the amount of unsecured liabilities assumed by the shareholder. See section 1.334-2 of the regulations.

Section 1031(a) of the Code provides, in part, that no gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Section 1223(1) of the Code provides, in part, that in determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which the taxpayer held the property exchanged if the property received has, for the purpose of determining gain or loss from the sale or exchange, the same basis in whole or in part in the taxpayer's hands as the property exchanged.

When property is received by a shareholder in the complete liquidation of a corporation and is thus treated as received in full payment in exchange for stock of the corporation, the period for which the taxpayer holds the property received in the liquidation includes the period for which the taxpayer held the stock of the liquidating corporation. See Rev. Rul. 74-522, 1974-2 C.B. 271.

In Rev. Rul. 75-292, 1975-2 C.B. 333, an individual taxpayer, in a prearranged transaction transferred land and buildings used in the taxpayer's trade or business to an unrelated corporation in exchange for land and an office building owned by the corporation and used in its trade or business. Immediately thereafter, the individual taxpayer transferred the land and office building to the individual's newly created corporation. Rev. Rul. 75-292 holds, in part, that the exchange does not qualify for nonrecognition of gain or loss under section 1031(a) of the Code with respect to the individual taxpayer, because the individual taxpayer did not exchange the land and buildings for property to be held either for productive use in trade or business or for investment. The newly created corporation's eventual productive use of the land and office building in trade or business is not attributable to its sole shareholder.

The proposed transaction between A and B was a prearranged plan whereby X was liquidated to facilitate a further exchange between A and B of their respective properties. The productive use of the shopping center by X prior to the liquidation cannot be attributed to A and, hence, A did not hold an interest in the shopping center for productive use in trade or business or for investment. Compare Rev. Rul. 75-292.

Accordingly, A's exchange of the shopping center for B's property does not qualify for nonrecognition of gain or loss under section 1031(a) of the Code.

Any gain or loss resulting from the exchange will be recognized to A to the extent of the difference between A's basis in the shopping center acquired as a result of the liquidation as determined pursuant to section 334(c) of the Code and the regulations thereunder, and the fair market value of B's property at the time of the exchange.

Pursuant to section 1223(1) of the Code and Rev. Rul. 74-522, the holding period of the shopping center acquired by A at the time of liquidation includes the period for which A held the stock in X.

TECHNICAL ADVICE MEMORANDUM 9645005

Internal Revenue Service
JUL 23, 1996
Release Date: JUL 23,1996

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

ISSUES:

1. Whether the sale of the Conveyance Property was, in substance, a sale by Partnership or its partners, Limited and Corporation Ii.

2. Whether Limited' s purchase of improved real property will be considered a purchase of property "similar or related in service or use" to the Conveyance Property for purposes of section 1033(g) of the Code.

FACTS:

Limited was organized as a limited partnership on Date j for the purpose of forming a joint venture with Corporation N. The joint venture, a general partnership (the "Partnership") was formed during the same month Limited was organized. Limited and Corporation N each held a 50 percent interest in Partnership.

On the date Partnership was organized, it purchased a parcel of undeveloped land (the "Property"). In the third calendar year following Date a, the Authority instituted condemnation proceedings against a portion of the Property (the "Conveyance Property"), after Partnership rejected Authority's initial offer to purchase that part of the Property. The Conveyance Property represented approximately 30 percent of the land that comprised the Property. Later in the same year in which the condemnation proceeding was initiated, an agreement was reached for the Authority ' s purchase of the Conveyance Property.

The Purchase and Sale Agreement (the "Agreement") for the Conveyance Property was dated as of Date d and indicated a purchase price of x dollars. The Agreement required the Authority to make an initial deposit of y dollars at the time the contract was executed. Additional deposits of z dollars were required on the last day of the third month following the execution of the Agreement and the first day of the fifth month following the execution of the Agreement if the sale of the Conveyance Property had not closed by that date. The three deposits represented approximately five percent of the sales price provided for in the Agreement. In the event the Authority did not close, the deposits and any interest earned thereon were to be retained by the seller as liquidated damages.

The Agreement provided that title work on the Conveyance Property was to be completed no later than the end of the month following the execution of the Agreement. The Authority's obligation to close was subject to no contingencies other than those expressly set forth in the Agreement. The Agreement specified Date g, the first day of the ninth month following the execution of the Agreement, as the closing date. The Authority could accelerate the closing date upon written notice to the seller ten business days in advance of the desired closing date.

If closing did not take place by date f, a date three months prior to the closing date specified in the Agreement, the Agreement imposed a requirement that the Authority pay interest, on a monthly basis, on the purchase price from date f to the time the sale closed. The Agreement gave the Authority the right to extend closing for a period of up to three months beyond date g if it made an additional deposit of y dollars and made monthly interest payments on the purchase price until closing.

The Agreement provided that any transfer of the Conveyance Property occurring prior to the closing of the sale governed by the Agreement would be subject to the terms and conditions of the Agreement and any transferee of the Conveyance Property would assume all obligations of Seller thereunder. Although the Agreement was non-assignable without the consent of the other party, it provided that the Seller (the Partnership) could distribute the Conveyance Property to its partners to hold as tenants in common and, in such event, the partners would have all the rights and obligations of the Seller, joint and several.

The Agreement required the Authority to provide a minimum of 10 days advance notice of the date selected for closing. The Authority selected date f, the latest date that would allow it to avoid paying interest on the purchase price prior to closing, for closing.

On date e, the day preceding the closing date, Partnership distributed fifty percent tenants-in-common interests in the Conveyance Property to Limited and Corporation N. The information provided by Limited indicates that the parties did not go through with the distribution of tenants-in-common interests to Limited and Corporation N until they had received indication from the Authority that it meant to close at the end of its 'interest free' period. However, once the timing and fact of actual closing was known, the parties caused Partnership to issue and record the tenants-in-common deed from Partnership to Limited and Corporation N on date e (the day preceding the closing)..

Incident to partnership's distribution of the tenants-in-common interests to Limited and Corporation N, an Assignment Agreement and an Assumption Agreement were executed on date e, the day preceding the distribution.

The Assumption Agreement, which was executed by Lender, Partnership, Limited, and Corporation N, provided that Limited and Corporation N jointly and severally agreed, subject to the limitations on liability set forth in section 28 of the Deed of Trust, to assume all of the obligations and jointly and severally covenanted, promised and agreed to pay the principal,' interest, and other sums due on the Note and to be bound by each and all of the obligations as though the documents originally had been executed and delivered by the Partnership, Limited, and Corporation N. Partnership

remained fully liable under the terms, provisions, covenants, and agreements of the Note and the Deed of Trust. Limited and Corporation N expressly waived any and all rights to partition the Conveyance Property or any portion thereof. In addition to the events of default specified in the Deed of Trust, the Lender's Assumption Agreement provided that the following events would constitute events of default:

a. Except in connection with the simultaneous repayment of the Note in full, any transfer or encumbrance of the Conveyance Property, or any portion thereof or any interest therein by Limited or Corporation N, except as otherwise required by the Assumption Agreement without the prior written consent of the Lender.

b. Any transfer or encumbrance of any general partnership interest in Limited or any controlling corporate interest in Corporation N to any person or entity without the prior written consent of the Lender.

c. If the Note had not been repaid in full by date h (the latest date to which the Authority could extend closing on the Conveyance Property under the terms of the Agreement), the failure by Limited and Corporation N to reconvey their respective interests in the Conveyance Property to Partnership not later than six days after date h.

d. The filing of any suit for partition of the Conveyance Property or any portion thereof.

The Assignment Agreement, which was executed by Partnership, Limited, and Corporation E, acknowledged Partnership's distribution to Limited and Corporation N of equal undivided tenants-in-common interests in the Conveyance Property and the Authority' s agreement to pay Limited and Corporation N each onehalf of the purchase price provided for in the Agreement. Although the Agreement provided that Limited and Corporation N would have all the rights and obligations of Partnership under the Agreement in the event the Conveyance Property were distributed to them, the Assignment Agreement provided that except as expressly modified thereunder, Partnership and the Authority retained all rights and obligations provided in the Agreement as well as all other covenants, agreements, representations, and warranties in the Agreement.

The closing of the sale of the Conveyance Property to the Authority took place on date f. Limited and Corporation Ii executed a Special Warranty Deed deeding the property to the Authority.

Limited elected, on its tax return for the taxable year in which the closing of the conveyance Property took place, to defer the gain from the disposition of the property pursuant to section 1033 of the Code.

LAW AND RATIONALE:

In order to determine whether section 1033 is applicable to Limited, it is necessary to determine whether the substance of the transaction governed by the Agreement represents a sale of the Conveyance Property by Partnership rather than a sale of tenants-in-common interests by Limited and Corporation ?i. Section 1033 is only applicable to the taxpayer that recognizes gain from an involuntary conversion, i.e., the seller. If Limited is not the seller, it can't defer gain pursuant to section 1033.

The substance of a transaction rather than the form in which the transaction is cast, generally, controls the tax consequences of a transaction. Court Holding Co. v. U.S., 324 U.S. 331 (1945) (purported sale by shareholders taxable to corporation that negotiated the sale). The realities and substance of the events govern the tax consequences rather than formalities and remote hypothetical possibilities. Corliss v. Bowers, 281 U.s. 376 (1930).

In United States v. Cumberland Public Service Co., 338 U.S. 451 (1950), the Supreme Court held shareholders of a liquidating corporation taxable on the sale of assets distributed by the corporation. The Supreme Court placed emphasis on the fact that the sale had been negotiated by the shareholders and the corporation at no time intended to sell the assets. The corporation had rejected an offer for sale of the assets. In Hines v. United States, 477 F.2d 1063 (5th Cir. 1973), the Fifth Circuit indicated that income from a sales transaction could not be imputed to a corporation unless the corporation participated in the sale (e.g., negotiation, prior agreement, postdistribution activities, etc.).

Sales negotiated by shareholders, acting as individuals rather than on behalf of the corporation, prior to distribution of corporate assets have not been imputed to the corporation. Doyle Hosiery Corporation v. Commissioner, 17 T.C. 641 (1951) (Sale not imputed to corporation where corporation did not consider, authorize, negotiate, or enter into any agreement for sale of assets and shareholders negotiated sale when in a position to do so, as individuals); Howell Turpentine Co. v. Commissioner, 162 F.2d 319 (5th Cir. 1947) (sale negotiated by shareholders prior to distribution of property).

In Waltham Netoco Theatres. Inc. v. Commissioner, 49 T.C. 399 (1968), the Tax Court held Waltham Netoco Theatres, Inc. ("Waltham"), which was the sole shareholder of Massachusetts Enterprises ("Enterprises") whose only asset was a parcel of land, taxable on the gain from sale of Enterprises stock by Waltham's shareholders. Waltham negotiated the sale of the land owned by Enterprises and reached an oral agreement for its sale. On the advice of counsel for Waltham, a contract was entered between each of the shareholders of Waltham and the purchaser for the sale of all of the stock of Enterprise rather than the land. Approximately two months after the agreement was executed, the directors of Waltham declared a dividend of all of the stock of Enterprises. On the same day but subsequent to the dividend declaration, all of the stockholders of Waltham endorsed their shares of Waltham to the purchaser.

The Tax Court noted that all of the negotiations were at the corporate level. There was no indication of a sale by Waltham's shareholders prior to the time the matter had been referred to the lawyers for the preparation of documents. The substitution of Enterprises stock for the land did not detract from the fact that the sale was never conceived and negotiated as a sale by Waltham's shareholders. In order to fall within the scope of Cumberland Public Service Co., it was necessary for Waltham to show that the sale was independently negotiated on behalf of its shareholders. The Tax Court noted that Waltham owned the Enterprises stock throughout the negotiations. The dividend in kind of the Enterprises stock was not distributed until the day of its prearranged transfer to the purchaser.

In Usher v. Commissioner, 45 T.C. 185 (1965), a taxpayer who transferred stock, which was subject to a binding sales contract, to a trust for her two sons, prior to consummating the sale, was held taxable on the full amount of the gain on sale of the stock in the year of sale. On January 28, 1960, all the stockholders of two corporations signed a "Memorandum of Understanding" with the purchaser whereby they agreed to sell and the purchaser agreed to buy all of the stock of the two corporations for $3 million. The memorandum of understanding provided that any of the stockholders' rights thereunder could be assigned to a purchaser of the stock upon the purchaser's assumption of the stockholder's obligations under that agreement. In the event a stockholder assigned any rights thereunder, the agreement provided that the stockholder would be deemed the guarantor of all the obligations of the stockholder's assignee under the agreement.

On February 8, 1960, the taxpayer, her two sons, the trustee of a trust the taxpayer's husband created for their two sons, the purchasing corporation, and the parent corporation of the purchasing corporation executed an agreement which recited that the taxpayer intended to sell and transfer some of the stock that was subject to the January 28, 1960, memorandum of understanding to the trustee. The agreement provided: the taxpayer would remain bound by all warranties in the memorandum of understanding as if the stock had not been transferred to the trustee; on the closing date, the trustee would sell and deliver the stock to the purchaser in accordance with the terms and conditions of the memorandum of understanding; the taxpayer's husband and two sons guaranteed the trustee's performance of the obligations which it would assume concerning the stock; and the parent of the purchasing corporation confirmed its guarantee of the purchaser's obligations under the memorandum of understanding.

On February 9, 1960, the taxpayer transferred a portion of the stock subject to the memorandum of understanding to the trustee of the trust created for her sons in return for specified semi-annual payments for the balance of her life. The shares transferred to the trust were transferred on the books of the corporation. At the closing, the trustee, represented as being one of the selling stockholders, agreed to accept the portion of the purchase price allocable to the shares held by the trustee and to place ten percent of that amount in escrow.

In concluding that the full amount of the gain realized on the sale of the stock, which was delivered by the trust at closing, was taxable to the taxpayer in the year of sale, the Tax Court noted that the taxpayer was obligated under the January 28, 1960 memorandum to sell the stock to the purchaser for a specified price. There was no question that the parties to the memorandum of understanding intended the stock to be sold in accordance with the terms of the memorandum. The memorandum recognized that any stockholder had the right to assign his rights under the memorandum provided the purchaser of the stock assumed the obligations of the selling stockholder under the memorandum. The taxpayer transferred her stock to the trust on the day the trust was created. The trust was bound to deliver the stock to the purchaser and receive the agreed purchase price. In the circumstances, the trust was a mere conduit to carry out the sale of stock for the taxpayer.

In Chase v. Commissioner, 92 T.C. 874 (1989), the Tax Court applied the doctrine of substance over form and concluded that the substance of a partner's purported sale of an undivided interest in apartments owned by a partnership was a partnership sale. The contract for sale of the apartments reflected the partnership as the seller. The taxpayer signed the contract as a general partner of the partnership. There was no indication that the taxpayers individually held any interest in the apartments that were the subject of the contract. When it was certain that the sale would close, the taxpayers caused the deed, which had been executed shortly after the receipt of an initial offer to purchase the apartments, to be recorded.

Although the form advocated by the taxpayer in Chase was inconsistent with the terms of the partnership agreement and the taxpayer did not adhere to the form adopted, the case evidences the court's application of substance over form in the context of a partnership. In that case the partner sought the potential use of section 1031 of the Code to defer gain on the sale of the apartments. In the instant case, the taxpayer seeks characterization of the subject transaction as a sale by partners in order to warrant the application of section 1033 to defer gain on the sale of the Conveyance Property.

In cases involving a transfer of stock after directors adopted and shareholders ratified a plan of complete liquidation under section 337 of the Code, as in effect prior to the Tax Reform Act of 1986, the transferor was held taxable on the liquidating dividend. In such circumstances, the donee did not have the legal capacity to rescind the decision to liquidate and was incapable of altering the transferor's intention that the transferee receive liquidation proceeds rather than an interest in an ongoing corporation. Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972); Kinsey v. Commissioner, 58 T.C. 259, 477 F.2d 1058 (2nd Cir. 1973). However, in circumstances where a plan of liquidation had not been adopted at the time stock was transferred even though liquidation was planned or the transferee was given sufficient voting interest to rescind the decision to liquidate, the liquidating distribution was held taxable to the transferee. Rushing v. Commissioner, 52 T.C. 888 (1969), aff'd. 441 F.2d 593 (5th Cir. 1971); Palmer v. Commissioner, 62 T.C. 684 (1974) (case involved a redemption rather than a liquidation).

The timing of Partnership's distribution of the tenants-in-common interests indicates that the distribution was intended to facilitate the use of Limited and Corporation E as conduits for the consummation of Partnership's sale of the Conveyance Property. Although the Agreement, which was executed five months before the distribution, provided for the potential of distribution of the Conveyance Property, the distribution was delayed until closing on the sale to the Authority was assured and imminent. Information furnished by Limited indicates that the parties did not go through with the distribution of the tenants-in-Common interests until they had received indication of the date the Authority selected for closing. However, once the timing and fact of actual closing was known, the parties caused Partnership to issue and· record the tenants-in-common deed from Partnership to Limited and Corporation N on date e (the day preceding the closing). Although the Agreement required the Authority to give at least 10 days advance notice of its desired closing date, Partnership's distribution was delayed until the day before closing.

The terms of the Assumption Agreement, which was executed on the date of Partnership's distribution of the tenants-in-common interests (the day before the scheduled closing), provide further evidence that Limited and Corporation N never had the burdens and benefits of ownership of the Conveyance Property. The Assumption Agreement prohibited partition of the Conveyance Property and the transfer, sale or encumbrance of any interest therein without the Lender's prior written consent unless the entire amount of the debt owed to Lender, which was secured by the Conveyance Property, was simultaneously retired. If the debt owed Lender had not been repaid in full by the latest closing date the Authority could have designated under the terms of the Agreement, Limited and Corporation N's failure to reconvey their tenants-in-common interests in the Conveyance Property to Partnership would constitute an event of default under the Assumption Agreement.

The terms of the Assumption Agreement virtually assured that neither Limited nor Corporation N could take any independent action with respect to their tenants-in-common interests in the Conveyance Property in the event the sale to the Authority did not close. Unless a co-tenant could obtain the Lender's consent, the sale or encumbrance of either co-tenant's interest would have required that co-tenant to satisfy the full amount of the debt secured by the Conveyance Property to the benefit of the other co-tenant.

As the result of receiving their tenants-tenants-in-common interests subject to the Agreement, Limited and Corporation N had no discretion to deal with the Conveyance Property as owners before the closing of the sale to the Authority. In the unlikely event that the sale had not closed (the Authority confirmed its intent to close the day preceding closing before Partnership distributed the tenants-in-common interests), the terms of the Assumption Agreement restricted the ability of Limited and Corporation N to independently deal with their tenants-in-common interests. Those restrictions, coupled with a requirement for reconveyance of the tenants-in-common interests to Partnership if the debt to the Lender were not repaid by the latest potential closing date which the Authority could designate under the terms of the Agreement, indicate that the parties did not intent to vest Limited or Corporation II with the burdens and benefits of ownership of the Conveyance Property.

Partnership's distribution of tenants-in-common interests in the Conveyance Property when the property was subject to a contract of sale foreclosed Limited and Corporation Ii's discretion to deal with the property as owners; Limited and Corporation ki' s negotiation, solely in their capacity as Partnership's general partners, of the terms of sale with the Authority; the execution of the Agreement for sale of the Conveyance Property indicating Partnership as Seller; the timing of Partnership's distribution of the tenants-in-common interests within hours of closing when closing was assured; and the Assignment Agreement acknowledging the obligations of Limited and Corporation N to deliver their tenants-in-common interests in the Conveyance Property to the Authority in return for the payment of the agreed purchase price, warrant a conclusion that Limited and Corporation I~ acted as conduits in carrying out Partnership's sale of the Conveyance Property. The substance of the transaction was the sale of the Conveyance Property by Partnership.

Limited and Corporation N, acting solely in their capacity as general partners of Partnership, negotiated the terms of sale with the Authority. Acting solely in their capacity as general partners, they executed the Agreement, which indicated Partnership was the Seller, on behalf of Partnership. Although the Agreement raised the prospect of assignment of the Agreement to Limited and Corporation N if partnership distributed the Conveyance Property to them, partnership was legally obligated to sell the Conveyance Property to the Authority regardless of whether the property were distributed to Limited and Corporation N. The Agreement did not require Partnership to distribute the Conveyance Property.

Although the substance of the transaction involving the sale of the Conveyance Property is a sale by Partnership, Limited could not avail itself of section 1033(g) even if it had sold its tenants-in-common interest in the Conveyance Property.

Section 1033(a) of the Code provides, in part, that if property (as a result of requisition or condemnation) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent the taxpayer, within the period specified in section 103(a) (2) (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property.

Section 1033(a) (2) (B) of the Code provides, in part, that the period referred to in section 1033(a) (2) (A) is the period beginning on the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate on application of the taxpayer.

Section 1033(g) (4) of the Code provides that in the case of a compulsory or involuntary conversion of: property held for productive use in a trade or business or for investment, section 1033(a) (2) (B) shall be applied by substituting "3 years" for "2 years."

Section 1033(g) (1) of the Code provides, in part, that for purposes of section 1033(a), if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as a result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1.1033(g)-1(a) of the Income Tax Regulations provides special rules for application of section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale). For purposes of the regulation, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation. In such case, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in the trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For purposes of determining whether the replacement property is property of like kind, see paragraph (b) of section 1.1031(a)-1 of the regulations.

Even if the sale of the Conveyance Property in the instant case were to be treated as a sale of a tenants-in-common interest by limited rather than a sale by Partnership, the circumstances would not satisfy the requirement of section 1033(g) 'of the Code that the involuntarily converted property have been held for productive use in trade or business or for investment. There is no indication that Limited held its tenants-in-common interest in the Conveyance Property for productive use in its trade or business during the one day period that it held the interest.

The circumstances are also inconsistent with the tenants-in- common interest being held for investment. Limited received the interest subject to the Agreement that was negotiated and executed by Partnership. Limited had no ability to increase the sales price of the Conveyance Property or otherwise enhance the benefits it would receive under the Agreement. Limited received the tenants- in-common interest subject to an obligation to

deliver it to the Authority the next day in return for a -predetermined cash payment. There is no indication that the tenants-in-common interest generated any income during the period it was held by Limited prior to delivery to the Authority at closing. The circumstances are inconsistent with Limited holding the tenants-in-common interest for investment.

Barker v. United States, 668 F. Supp. 1199 (C.D. Ill. 1987), considered circumstances in which a taxpayer entered an agreement with the owner of farmland which provided that the taxpayer would acquire property suitable to the owner of the farmland and exchange the property for the farmland. After the taxpayer located a restaurant property suitable to the owner of the farmland, the parties executed an agreement that determined the respective values for the properties. The closing for both the sale of the restaurant and the exchange of the farmland took place the same day. In holding that the exchange was not governed by section 1031 of the Code, the court indicated that it would be difficult to conclude the taxpayer's acquisition of the restaurant solely for the purpose of exchanging it for the farmland was in any way for the productive use in the taxpayer's trade or business. The court also indicated that the simultaneous closing on the restaurant and the exchange transaction did not evidence an investment intent in the acquisition of the restaurant.

Rev. Rul. 84-121, 1984-2 C.B. 168, concludes that section 1031 of the Code is not applicable to an exchange of property with respect to a taxpayer who acquired property and immediately transferred the property in satisfaction of the exercise price of an option for the purchase of other property. Section 1031 is not applicable because the property which the taxpayer transferred was not used in the taxpayer's trade or business or held for investment.

Limited argues that Rev. Rul. 81-181, 1981-2 C.B. 162, is inconsistent with the decision in Barker v. United States, supra. Rev. Rul. 81-181 concludes that the sale of property to a city by a taxpayer who acquired the property from its former owner with the knowledge that the property was under threat of condemnation qualifies as an involuntary conversion under section 1033 of the Code. The Rev. Rul. does not conclude that section 1033 (g), rather than section 1033 (a), is applicable to the intermediate purchaser's sale to the city; it concludes only that the sale to the city is an involuntary conversion. Section 1033(a) does not require that involuntarily converted property have been held for productive use in a trade or business or for investment. The Rev. Rul. is not inconsistent with Barker v. United States since that case concerned the application of section 1031(a) which has the same "held for productive use in a trade of business or for investment" standard as section 1033(g).

A conclusion that Limited did not hold the tenants-in-common interest for investment or productive use in a trade or business is consistent with the decision in Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985). The Ninth Circuit held that "[i]f a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in trade or business or for investment' within the meaning of section 1031(a)." Acquisition of property that is subject to a sales contract that is to close the next day is inconsistent with holding the property for investment or for productive use in a trade or business, and a conclusion that liquidation of the property was not intended. See Rev. Rul. 84-121.

In Bolker, a shareholder executed an agreement, on the date of receipt of a liquidating distribution, to exchange the property received. The actual exchange took place three months later. At the time the plan of liquidation was adopted, the shareholder had not contemplated disposition of the property. The property received in liquidation was not subject to an agreement for its exchange when received by the shareholder.

CONCLUSIONS:

1. The sale of the Conveyance Property was, in substance, a sale by Partnership.

2. Limited's purchase of improved real property will not be considered a purchase of property "similar or related in service or use" to the Conveyance Property for purposes of section 1033(g) of the Code.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j) (3) of the Code provides that it may not be used or cited as precedent.

DISREGARDED ENTITIES

DISREGARDED ENTITIES (ARTICLE)

This flyer summarizes rules relating to entities that may be "disregarded" for purposes of IRC Section 1031 and is designed to assist in cases where the Exchanger desires to title the replacement property in a manner that is different from title to the relinquished property. In all cases, an Exchanger should consult with their tax or legal advisor to ensure that the desired structure is acceptable for IRC Section 1031 purposes.

GENERAL RULES

1) Virtually any natural or legal person (individual, corporation, Partnership, LLC, trust, etc.) may do an IRC Section 1031 exchange.

2) The seller of the relinquished property (generally as determined by the status of legal title) must also be the buyer of the replacement roperty, e.g., if John Q. Public is on title to the relinquished property, then John Q. Public must acquire title to the replacement property.

EXCEPTION TO RULE 2

If the transferor of the relinquished property or the transferee of the replacement property is a "disregarded entity" (See Treas. Reg. §301.7701) or the "owner" of a disregarded entity, then the entity is treated as if it does not exist and the owner and the entity are, in effect, interchangeable as the Exchanger, i.e., the entity may sell and the owner may buy and vice versa. For example, if A owns 100% of the interests in an entity that is a "disregarded entity" then A may sell the relinquished property and the entity may take title to the replacement property and vice versa.

WHAT ENTITIES ARE NOT DISREGARDED?

C ("regular") Corporations:	Not disregarded
S Corporations:	Not disregarded
General Partnerships:	Not disregarded
Limited Partnerships:	Not disregarded

The IRS has ruled that where an otherwise non-disregarded entity has two members under local law, but one of the members is a disregarded entity that is owned by the other member, the eligible entity is treated as having only one member. Thus, the entity cannot be a partnership for tax purposes; it must be classified either as a disregarded entity or as an association taxable as a corporation. [Rev. Rul. 2004-77, 2004-31 I.R.B. 119]

LIMITED LIABILITY COMPANIES (LLCs)

LLCs are not disregarded except in the following cases where the LLC has <u>not</u> made an election to be treated for tax purposes as a corporation:

- 100% of the interests are owned by a single legal or natural person. [PLRs 9751012; 9807013; 19911033]
- 100% of the interests are owned by husband and wife as community property in a community property state. [Rev. Proc. 2002-69, 2002-2 CB831]

The IRS has ruled that a two-member LLC formed under Delaware law was disregarded for §1031 exchange purposes where all economic interests were held by one member and the function of the second member was solely to prevent a bankruptcy filing or other violation of the LLC's covenants with lenders [PLR 199911033]. The IRS has ruled that the acquisition of all the ownership interests held by 2 different owners by a single buyer in a single transaction constituted an acquisition of the underlying assets owned by the LLC. [Rev. Rul. 99-6, 1991-1 C.B 432]

DISREGARDED ENTITIES

TREASURY REGULATIONS
Sec. 301.7701-1 Classification of organizations for federal tax purposes.

(a) Organizations for federal tax purposes

(1) In general

The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

(2) Certain joint undertakings give rise to entities for federal tax purposes

A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(3) Certain local law entities not recognized

An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. 477, or under section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C. 503, are not recognized as separate entities for federal tax purposes.

(4) Single owner organizations

Under sections 301.7701-2 and 301.7701-3, certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.

(b) Classification of organizations

The classification of organizations that are recognized as separate entities is determined under sections 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Internal Revenue Code (such as section 860A addressing Real Estate Mortgage Investment Conduits (REMICs)) provides for special treatment of that organization. For the classification of organizations as trusts, see section 301.7701-4. That section provides that trusts generally do not have associates or an objective to carry on business for profit. Sections 301.7701-2 and 301.7701-3 provide rules for classifying organizations that are not classified as trusts.

(c) Qualified cost sharing arrangements

A qualified cost sharing arrangement that is described in section 1.482-7 of this chapter and any arrangement that is treated by the Commissioner as a qualified cost sharing arrangement under section 1.482-7 of this chapter is not recognized as a separate entity for purposes of the Internal Revenue Code. See section 1.482-7 of this chapter for the proper treatment of qualified cost sharing arrangements.

(d) Domestic and foreign entities

For purposes of this section and sections 301.7701-2 and 301.7701-3, an entity is a domestic entity if it is created or organized in the United States or under the law of the United States or of any State; an entity is foreign if it is not domestic. See sections 7701(a)(4) and (a)(5).

(e) State

For purposes of this section and section 301.7701-2, the term State includes the District of Columbia.

(f) Effective date

The rules of this section are effective as of January 1, 1997.

Sec. 301.7701-2 Business entities; definitions.

(a) Business entities

For purposes of this section and section 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under section 301.7701-3) that is not properly classified as a trust under section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

(b) Corporations

For federal tax purposes, the term corporation means—

(1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under section 301.7701-3);

(3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute;

(6) A business entity wholly owned by a State or any political subdivision thereof;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3);

(8) Certain foreign entities

(i) In general

Except as provided in paragraphs (b)(8)(ii) and (d) of this section, the following business entities formed in the following jurisdictions:

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company
Austria, Aktiengesellschaft
Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company
Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Canada, Corporation and Company
Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Colombia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost
Denmark, Aktieselskab
Ecuador, Sociedad Anonima or Compania Anonima
Egypt, Sharikat Al-Mossahamah
El Salvador, Sociedad Anonima
Estonia, Aktsiaselts
European Economic Area/European Union, Societas Europaea
Finland, Julkinen Osakeyhtio/Publikt Aktiebolag
France, Societe Anonyme
Germany, Aktiengesellschaft
Greece, Anonymos Etairia
Guam, Corporation
Guatemala, Sociedad Anonima
Guyana, Public Limited Company

Honduras, Sociedad Anonima
Hong Kong, Public Limited Company
Hungary, Reszvenytarsasag
Iceland, Hlutafelag
India, Public Limited Company
Indonesia, Perseroan Terbuka
Ireland, Public Limited Company
Israel, Public Limited Company
Italy, Societa per Azioni
Jamaica, Public Limited Company
Japan, Kabushiki Kaisha
Kazakstan, Ashyk Aktsionerlik Kogham
Republic of Korea, Chusik Hoesa
Latvia, Akciju Sabiedriba
Liberia, Corporation
Liechtenstein, Aktiengesellschaft
Lithuania, Akcine Bendroves
Luxembourg, Societe Anonyme
Malaysia, Berhad
Malta, Public Limited Company
Mexico, Sociedad Anonima
Morocco, Societe Anonyme
Netherlands, Naamloze Vennootschap
New Zealand, Limited Company
Nicaragua, Compania Anonima
Nigeria, Public Limited Company
Northern Mariana Islands, Corporation
Norway, Allment Aksjeselskap
Pakistan, Public Limited Company
Panama, Sociedad Anonima
Paraguay, Sociedad Anonima
Peru, Sociedad Anonima
Philippines, Stock Corporation
Poland, Spolka Akcyjna
Portugal, Sociedade Anonima
Puerto Rico, Corporation
Romania, Societe pe Actiuni
Russia, Otkrytoye Aktsionernoy Obshchestvo
Saudi Arabia, Sharikat Al-Mossahamah
Singapore, Public Limited Company
Slovak Republic, Akciova Spolocnost
Slovenia, Delniska Druzba
South Africa, Public Limited Company
Spain, Sociedad Anonima
Surinam, Naamloze Vennootschap
Sweden, Publika Aktiebolag
Switzerland, Aktiengesellschaft
Thailand, Borisat Chamkad (Mahachon)
Trinidad and Tobago, Limited Company
Tunisia, Societe Anonyme
Turkey, Anonim Sirket
Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu
United Kingdom, Public Limited Company
United States Virgin Islands, Corporation
Uruguay, Sociedad Anonima
Venezuela, Sociedad Anonima or Compania Anonima

(ii) Clarification of list of corporations in paragraph (b)(8)(i) of this section

(A) Exceptions in certain cases

The following entities will not be treated as corporations under paragraph (b)(8)(i) of this section:

(1) With regard to Canada, any corporation or company formed under any federal or provincial law which provides that the liability of all of the members of such corporation or company will be unlimited; and

(2) With regard to India, a company deemed to be a public limited company solely by operation of Section 43A(1) (relating to corporate ownership of the company), section 43A(1A) (relating to annual average turnover), or section 43A(1B) (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of section 3(1)(iii) of the Companies Act, 1956.

(3) With regard to Malaysia, a Sendirian Berhad.

(B) Inclusions in certain cases

With regard to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable).

(iii) Public companies

For purposes of paragraph (b)(8)(i) of this section, with regard to Cyprus, Hong Kong, and Jamaica, the term Public Limited Company includes any Limited Company that is not defined as a private company under the corporate laws of those jurisdictions. In all other cases, where the term Public Limited Company is not defined, that term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction.

(iv) Limited companies

For purposes of this paragraph (b)(8), any reference to a Limited Company includes, as the case may be, companies limited by shares and companies limited by guarantee.

(v) Multilingual countries

Different linguistic renderings of the name of an entity listed in paragraph (b)(8)(i) of this section shall be disregarded. For example, an entity formed under the laws of Switzerland as a Societe Anonyme will be a corporation and treated in the same manner as an Aktiengesellschaft.

(c) Other business entities

For federal tax purposes—

(1) The term partnership means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) Wholly owned entities

(i) In general

A business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

(ii) Special rule for certain business entities

If the single owner of a business entity is a bank (as defined in section 581), then the special rules applicable to banks will continue to apply to the single owner as if the wholly owned entity were a separate entity.

(iii) Tax liabilities of certain disregarded entities

(A) In general

An entity that is otherwise disregarded as separate from its owner is treated as an entity separate from its owner for purposes of:

(1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded.

(2) Federal tax liabilities of any other entity for which the entity is liable.

(3) Refunds or credits of Federal tax.

(B) Examples

The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:

Example 1. In 2001, X, a domestic corporation that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, Z is the successor to X and is liable for all of X's debts. In 2004, the Internal Revenue Service ("IRS")

seeks to extend the period of limitations on assessment for X's 2000 taxable year. Because Z is the successor to X and is liable for X's 2000 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations.

Example 2. The facts are the same as in Example 1, except that in 2002, the IRS determines that X miscalculated and underreported its income tax liability for 2000. Because Z is the successor to X and is liable for X's 2000 taxes that remain unpaid, the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.

(d) Special rule for certain foreign business entities

(1) In general

Except as provided in paragraph (d)(3) of this section, a foreign business entity described in paragraph (b)(8)(i) of this section will not be treated as a corporation under paragraph (b)(8)(i) of this section if—

(i) The entity was in existence on May 8, 1996;

(ii) The entity's classification was relevant (as defined in section 301.7701-3(d)) on May 8, 1996;

(iii) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(iv) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(v) A reasonable basis (within the meaning of section 6662) existed on May 8, 1996, for treating the entity as other than a corporation; and

(vi) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

(2) Binding contract rule

If a foreign business entity described in paragraph (b)(8)(i) of this section is formed after May 8, 1996, pursuant to a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and all times thereafter, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, paragraph (d)(1) of this section will be applied to that entity by substituting the date of the entity's formation for May 8, 1996.

(3) Termination of grandfather status

(i) In general

An entity that is not treated as a corporation under paragraph (b)(8)(i) of this section by reason of paragraph (d)(1) or (d)(2) of this section will be treated permanently as a corporation under paragraph (b)(8)(i) of this section from the earliest of:

(A) The effective date of an election to be treated as an association under section 301.7701-3;

(B) A termination of the partnership under section 708(b)(1)(B) (regarding sale or exchange of 50 percent or more of the total interest in an entity's capital or profits within a twelve month period); or

(C) A division of the partnership under section 708(b)(2)(B).

(ii) Special rule for certain entities

For purposes of paragraph (d)(2) of this section, paragraph (d)(3)(i)(B) of this section shall not apply if the sale or exchange of interests in the entity is to a related person (within the meaning of sections 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity.

(e) Effective date

(1) Except as otherwise provided in this paragraph (e), the rules of this section apply as of January 1, 1997, except that paragraph (b)(6) of this section applies on or after January 14, 2002, to a business entity wholly owned by a foreign government regardless of any prior entity classification, and paragraph (c)(2)(ii) of this section applies to taxable years beginning after January 12, 2001. The reference to the Finnish, Maltese, and Norwegian entities in paragraph (b)(8)(i) of this section is applicable on November 29, 1999. The reference to the Trinidadian entity in paragraph (b)(8)(i) of this section applies to entities formed on or after November 29, 1999. Any Maltese or Norwegian entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including January 1, 1997. Any

Finnish entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on November 29, 1999, may elect by February 14, 2000, to be classified for Federal tax purposes as an entity other than a corporation retroactive to any period from and including September 1, 1997.

(2) Paragraph (c)(2)(iii) of this section applies on or after April 1, 2004.

(3) [Reserved]. For further guidance, see §301.7701-2T(f).

(4) The reference to the Estonian, Latvian, Liechtenstein, Lithuanian, and Slovenian entities in paragraph (b)(8)(i) of this section applies to such entities formed on or after October 7, 2004, and to any such entity formed before such date from the date any person or persons, who were not owners of the entity as of October 7, 2004, own in the aggregate a 50 percent or greater interest in the entity. The reference to the European Economic Area/European Union entity in paragraph (b)(8)(i) of this section applies to such entities formed on or after October 8, 2004.

Sec. 301.7701-3 Classification of certain business entities.

(a) In general

A business entity that is not classified as a corporation under section 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under section 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) of this section provides special rules for foreign eligible entities. Paragraph (e) of this section provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) Classification of eligible entities that do not file an election –

(1) Domestic eligible entities

Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is –

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) Foreign eligible entities

(i) In general

Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is—

(A) A partnership if it has two or more members and at least one member does not have limited liability;

(B) An association if all members have limited liability; or

(C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(ii) Definition of limited liability

For purposes of paragraph (b)(2)(i) of this section, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

(3) Existing eligible entities

(i) In general

Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under sections 301.7701-1 through 301.7701-3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i). For special rules regarding the classification of such entities for periods prior to the effective date of this section, see paragraph (f)(2) of this section.

(ii) Special rules

For purposes of paragraph (b)(3)(i) of this section, a foreign eligible entity is treated as being in existence prior to the effective date of this section only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section. If an entity claimed different classifications prior to the effective date of this section, the entity's classification for purposes of paragraph (b)(3)(i) of this section is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to the effective date of this section, but no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity, the entity's classification for the period prior to the effective date of this section is determined under the regulations in effect on the date prior to the effective date of this section.

(c) Elections

(1) Time and place for filing

(i) In general

Except as provided in paragraphs (c)(1)(iv) and (v) of this section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See section 301.6109-1 for rules on applying for and displaying Employer Identification Numbers.

(ii) Further notification of elections

An eligible entity required to file a federal tax or information return for the taxable year for which an election is made under paragraph (c)(1)(i) of this section must attach a copy of its Form 8832 to its federal tax or information return for that year. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal income tax or information return of any direct or indirect owner of the entity for the taxable year of the owner that includes the date on which the election was effective. An indirect owner of the entity does not have to attach a copy of the Form 8832 to its return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. If an entity, or one of its direct or indirect owners, fails to attach a copy of a Form 8832 to its return as directed in this section, an otherwise valid election under paragraph (c)(1)(i) of this section will not be invalidated, but the non-filing party may be subject to penalties, including any applicable penalties if the federal tax or information returns are inconsistent with the entity's election under paragraph (c)(1)(i) of this section.

(iii) Effective date of election

An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

(iv) Limitation

If an eligible entity makes an election under paragraph (c)(1)(i) of this section to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the sixty months succeeding the effective date of the election. However, the Commissioner may permit the entity to change its classification by election within the sixty months if more than fifty percent of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election. An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

(v) Deemed elections

(A) Exempt organizations

An eligible entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

(B) Real estate investment trusts

An eligible entity that files an election under section 856(c)(1) to be treated as a real estate investment trust is treated as having made an election under this section to be classified as an association. Such election will be effective as of the first day the entity is treated as a real estate investment trust.

(vi) Examples. The following examples illustrate the rules of this paragraph (c)(1):

Example 1

On July 1, 1998, X, a domestic corporation, purchases a 10% interest in Y, an eligible entity formed under Country A law in 1990. The entity's classification was not relevant to any person for federal tax or information purposes prior to X's acquisition of an interest in Y. Thus, Y is not considered to be in existence on the effective date of this section for purposes of paragraph (b)(3) of this section. Under the applicable Country A statute, all members of Y have limited liability as defined in paragraph (b)(2)(ii) of this section. Accordingly, Y is classified as an association under paragraph (b)(2)(i)(B) of this section unless it elects under this paragraph (c) to be classified as a partnership. To be classified as a partnership as of July 1, 1998, Y must file a Form 8832 by September 14, 1998. See paragraph (c)(1)(i) of this section. Because an election cannot be effective more than 75 days prior to the date on which it is filed, if Y files its Form 8832 after September 14, 1998, it will be classified as an association from July 1, 1998, until the effective date of the election. In that case, it could not change its classification by election under this paragraph (c) during the sixty months succeeding the effective date of the election.

Example 2

(i) Z is an eligible entity formed under Country B law and is in existence on the effective date of this section within the meaning of paragraph (b)(3) of this section. Prior to the effective date of this section, Z claimed to be classified as an association. Unless Z files an election under this paragraph (c), it will continue to be classified as an association under paragraph (b)(3) of this section.

(ii) Z files a Form 8832 pursuant to this paragraph (c) to be classified as a partnership, effective as of the effective date of this section. Z can file an election to be classified as an association at any time thereafter, but then would not be permitted to change its classification by election during the sixty months succeeding the effective date of that subsequent election.

(2) Authorized signatures

(i) In general

An election made under paragraph (c)(1)(i) of this section must be signed by –

(A) Each member of the electing entity who is an owner at the time the election is filed; or

(B) Any officer, manager, or member of the electing entity who is authorized (under local law or the entity's organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

(ii) Retroactive elections

For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is to be effective for any period prior to the time that it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election.

(iii) Changes in classification

For paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is made to change the classification of an entity, each person who was an owner on the date that any transactions under paragraph (g) of this section are deemed to occur, and who is not an owner at the time the election is filed, must also sign the election. This paragraph (c)(2)(iii) applies to elections filed on or after November 29, 1999.

(d) Special rules for foreign eligible entities

(1) Definition of relevance

For purposes of this section, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes.

For example, a foreign entity's classification would be relevant if U.S. income was paid to the entity and the determination by the withholding agent of the amount to be withheld under chapter 3 of the Internal Revenue Code (if any) would vary depending upon whether the entity is classified as a partnership or as an association. Thus, the classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared. The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in the entity is acquired which will require a U.S. person to file an information return on Form 5471.

(2) Special rule when classification is no longer relevant

If the classification of a foreign eligible entity which was previously relevant for federal tax purposes ceases to be relevant for sixty consecutive months, the entity's classification will initially be determined under the default classification when the classification of the foreign eligible entity again becomes relevant. The date that the classification of a foreign entity ceases to be relevant is the date an event occurs that causes the classification to no longer be relevant, or, if no event occurs in a taxable year that causes the classification to be relevant, then the date is the first day of that taxable year.

(e) Coordination with section 708(b)

Except as provided in section 301.7701-2(d)(3) (regarding termination of grandfather status for certain foreign business entities), an entity resulting from a transaction described in section 708(b)(1)(B) (partnership termination due to sales or exchanges) or section 708(b)(2)(B) (partnership division) is a partnership.

(f) Changes in number of members of an entity

(1) Associations

The classification of an eligible entity as an association is not affected by any change in the number of members of the entity.

(2) Partnerships and single member entities

An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member. A single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member. If an elective classification change under paragraph (c) of this section is effective at the same time as a membership change described in this paragraph (f)(2), the deemed transactions in paragraph (g) of this section resulting from the elective change preempt the transactions that would result from the change in membership.

(3) Effect on sixty month limitation

A change in the number of members of an entity does not result in the creation of a new entity for purposes of the sixty month limitation on elections under paragraph (c)(1)(iv) of this section.

(4) Examples

The following examples illustrate the application of this paragraph (f):

Example 1

A, a U.S. person, owns a domestic eligible entity that is disregarded as an entity separate from its owner. On January 1, 1998, B, a U.S. person, buys a 50 percent interest in the entity from A. Under this paragraph (f), the entity is classified as a partnership when B acquires an interest in the entity. However, A and B elect to have the entity classified as an association effective on January 1, 1998. Thus, B is treated as buying shares of stock on January 1, 1998. (Under paragraph (c)(1)(iv) of this section, this election is treated as a change in classification so that the entity generally cannot change its classification by election again during the sixty months succeeding the effective date of the election.) Under paragraph (g)(1) of this section, A is treated as contributing the assets and liabilities of the entity to the newly formed association immediately before the close of December 31, 1997. Because A does not retain control of the association as required by section 351, A's contribution will be a taxable event. Therefore, under section 1012, the association will take a fair market value basis in the assets contributed by A, and A will have a fair market value basis in the stock received. A will have no additional gain upon the sale of stock to B, and B will have a cost basis in the stock purchased from A.

Example 2

(i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and X does not make an election to be classified as a partnership. A subsequently purchases all of B's interest in X.

(ii) Under paragraph (f)(1) of this section, X continues to be classified as an association. X, however, can subsequently elect to be disregarded as an entity separate from A. The sixty month limitation of paragraph (c)(1)(iv) of this section does not prevent X from making an election because X has not made a prior election under paragraph (c)(1)(i) of this section.

Example 3

(i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and X does not make an election to be classified as a partnership. On January 1, 1999, X elects to be classified as a partnership effective on that date. Under the sixty month limitation of paragraph (c)(1)(iv) of this section, X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after the effective date of the election to be classified as a partnership).

(ii) On June 1, 2000, A purchases all of B's interest in X. After A's purchase of B's interest, X can no longer be classified as a partnership because X has only one member. Under paragraph (f)(2) of this section, X is disregarded as an entity separate from A when A becomes the only member of X. X, however, is not treated as a new entity for purposes of paragraph (c)(1)(iv) of this section. As a result, the sixty month limitation of paragraph (c)(1)(iv) of this section continues to apply to X, and X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after January 1, 1999, the effective date of the election by X to be classified as a partnership).

(5) Effective date

This paragraph (f) applies as of November 29, 1999.

(g) Elective changes in classification

(1) Deemed treatment of elective change

(i) Partnership to association

If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

(ii) Association to partnership

If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

(iii) Association to disregarded entity

If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

(iv) Disregarded entity to an association

If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) Effect of elective changes

(i) In general

The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(ii) Adoption of plan of liquidation

For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332, unless a formal plan of liquidation that contemplates the election to be classified as a partnership or to be disregarded as an entity separate from its owner is adopted on an earlier date, the making, by an association, of an election under paragraph (c)(1)(i) of this section to be classified as a partnership or to be disregarded as an entity separate from its owner is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in paragraph (g)(1)(ii) or (iii) of this section. This paragraph (g)(2)(ii) applies to elections filed on or after December 17, 2001. Taxpayers may apply this paragraph (g)(2)(ii) retroactively to elections filed before December 17, 2001, if the corporate owner claiming treatment under section 332 and its subsidiary making the election take consistent positions with respect to the federal tax consequences of the election.

(3) Timing of election

(i) In general

An election under paragraph (c)(1)(i) of this section that changes the classification of an eligible entity for federal tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under this paragraph (g) as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions specified in paragraph (g)(1)(ii) of this section (including the liquidation of the association) are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

(ii) Coordination with section 338 election

A purchasing corporation that makes a qualified stock purchase of an eligible entity taxed as a corporation may make an election under section 338 regarding the acquisition if it satisfies the requirements for the election, and may also make an election to change the classification of the target corporation. If a taxpayer makes an election under section 338 regarding its acquisition of another entity taxable as a corporation and makes an election under paragraph (c) of this section for the acquired corporation (effective at the earliest possible date as provided by paragraph (c)(1)(iii) of this section), the transactions under paragraph (g) of this section are deemed to occur immediately after the deemed asset purchase by the new target corporation under section 338.

(iii) Application to successive elections in tiered situations

When elections under paragraph (c)(1)(i) of this section for a series of tiered entities are effective on the same date, the eligible entities may specify the order of the elections on Form 8832. If no order is specified for the elections, any transactions that are deemed to occur in this paragraph (g) as a result of the classification change will be treated as occurring first for the highest tier entity's classification change, then for the next highest tier entity's classification change, and so forth down the chain of entities until all the transactions under this paragraph (g) have occurred. For example, Parent, a corporation, wholly owns all of the interest of an eligible entity classified as an association (S1), which wholly owns another eligible entity classified as an association (S2), which wholly owns another eligible entity classified as an association (S3). Elections under paragraph (c)(1)(i) of this section are filed to classify S1, S2, and S3 each as disregarded as an entity separate from its owner effective on the same day. If no order is specified for the elections, the following transactions are deemed to occur under this paragraph (g) as a result of the elections, with each successive transaction occurring on the same day immediately after the preceding transaction: S1 is treated as liquidating into Parent, then S2 is treated as liquidating into Parent, and finally S3 is treated as liquidating into Parent.

(4) Effective date

Except as otherwise provided in paragraph (g)(2)(ii) of this section, this paragraph (g) applies to elections that are filed on or after November 29, 1999. Taxpayers may apply this paragraph (g) retroactively to elections filed before November 29, 1999 if all taxpayers affected by the deemed transactions file consistently with this paragraph (g).

(h) Effective date

(1) In general

Except as otherwise provided in this section, the rules of this section are applicable as of January 1, 1997.

(2) Prior treatment of existing entities

In the case of a business entity that is not described in section 301.7701-2(b)(1), (3), (4), (5), (6), or (7), and that was in existence prior to January 1, 1997, the entity's claimed classification(s) will be respected for all periods prior to January 1, 1997, if—

(i) The entity had a reasonable basis (within the meaning of section 6662) for its claimed classification;

(ii) The entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to January 1, 1997; and

(iii) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

REVENUE RULING 2004-77

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: August 2, 2004

Section 1031 — Exchange of Property Held for Productive Use or Investment

DISREGARDED ENTITIES

Section 7701 -- Definitions, 26 CFR 301.7701-1: Classification of organizations for federal tax purposes. Disregarded entities. This ruling concludes that, if an eligible entity has two owners under local law, but one of the owners is, for federal tax purposes, disregarded as an entity separate from the other owner of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation.

ISSUE

How is an eligible entity (as defined in Section 301.7701-3(a) of the Procedure and Administration Regulations) classified for federal tax purposes if the entity has two members under local law, but one of the members of the eligible entity is disregarded as an entity separate from the other member of the eligible entity for federal tax purposes?

FACTS

Situation 1. X, a domestic corporation, is the sole owner of L, a domestic limited liability company (LLC). Under Section 301.7701-3(b)(1), L is disregarded as an entity separate from its owner, X. L and X are the only members under local law of P, a state law limited partnership or LLC. There are no other constructive or beneficial owners of P other than L and X. L and P are eligible entities that do not elect under Section 301.7701-3(c) to be treated as associations for federal tax purposes.

Situation 2. X is an entity that is classified as a corporation under Section 301.7701-2(b). X is the sole owner of L, a foreign eligible entity. Under Section 301.7701-3(c), L has elected to be disregarded as an entity separate from its owner. L and X are the only members under local law of P, a foreign eligible entity. There are no other constructive or beneficial owners of P other than L and X.

LAW AND ANALYSIS

Section 7701(a)(2) of the Internal Revenue Code provides that the term partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a trust, estate, or corporation.

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Section 301.7701-3) that is not properly classified as a trust under Section 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-2(c)(1) provides that, for federal tax purposes, the term "partnership" means a business entity that is not a corporation under Section 301.7701-2(b) and that has at least two owners.

Section 301.7701-2(c)(2)(i) provides, in general, that a business entity that has a single owner and is not a corporation under Section 301.7701-2(b) is disregarded as an entity separate from its owner.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under Section 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. An eligible entity with at least two owners can elect to be classified as either an association (and thus a corporation under Section 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1) provides generally that in the absence of an election otherwise, a domestic eligible entity is (a) a partnership if it has at least two members, or (b) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-3(b)(2) provides generally that, in the absence of an election otherwise, a foreign eligible entity is (a) a partnership if it has two or more owners and at least one owner does not have limited liability, (b) an association if all its owners have limited liability, or (c) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Situation 1. Under Section 301.7701-2(c)(2), L is disregarded as an entity separate from its owner, X, and its activities are treated in the same manner as a branch or division of X. Because L is disregarded as an entity separate from X, X is treated as owning all of the interests in P. P is a domestic

entity, with only one owner for federal tax purposes, that has not made an election to be classified as an association taxable as a corporation. Because P has only one owner for federal tax purposes, P cannot be classified as a partnership under Section 7701(a)(2). For federal tax purposes, P is disregarded as an entity separate from its owner.

Situation 2. Under Section 301.7701-3(c), L is disregarded as an entity separate from its owner, X, and its activities are treated in the same manner as a branch or division of X. Because L is disregarded as an entity separate from X, X is treated as owning all of the interests in P. Because P has only one owner for federal tax purposes, P cannot be classified as a partnership under Section 7701(a)(2). For federal tax purposes, P is either disregarded as an entity separate from its owner or an association taxable as a corporation.

HOLDING

If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jason T. Smyczek of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Smyczek at (202) 622-3050 (not a toll-free call).

REVENUE RULING 2004-31

PURPOSE

The Service is aware that some individuals are attempting to reduce their federal income tax obligations by claiming that they have been "removed" or "redeemed" from the federal tax system. Although the specific arguments made by these individuals vary, some argue that the Government commits a fraud when it attempts to collect debts, including tax debts, and that this purported fraud allows individuals to "chargeback" debts that the Government purportedly owes to these individuals to eliminate any asserted tax liability. "Removal," "redemption," and "chargeback" schemes are referred to here collectively as "removal schemes" and "removal arguments." Some promoters are marketing a package, kit, or other materials that claim to show individuals how they can avoid paying income taxes based on these and other meritless arguments.

This revenue ruling emphasizes to individuals, and to promoters and return preparers who assist individuals with these schemes, that there is no authority under any U.S. law that supports the argument that an individual can be "removed" or "redeemed" from the federal tax system to avoid tax liabilities or that an individual can satisfy debts, including tax liabilities, by making "chargeback" or other similar arguments. Removal and redemption arguments have no merit and are frivolous.

The Service is committed to identifying individuals who attempt to avoid or evade their tax obligations. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the IRS are processed through the Service's Frivolous Return Program. As part of this program, the Service confirms whether taxpayers who take frivolous positions have filed all of their required tax returns, computes the correct amount of tax and interest due, and determines whether civil and criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether a court injunction should be sought to halt such activities. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

DISCUSSION OF REMOVAL AND REDEMPTION ARGUMENTS AND SCHEMES

Removal arguments and schemes are loosely related and take a variety of different forms. Proponents of removal arguments and schemes typically claim, even though they remain citizens or residents of the U.S., that they are not required to file federal tax returns and pay their tax obligations because they have been removed or redeemed from the federal tax system. As a result of participating in removal schemes, these individuals do not file required returns or pay the income tax that they owe.

In some variations of the removal argument, individuals claim that the Government commits a fraud when it attempts to collect debts, including tax debts, and that this purported fraud allows individuals to "chargeback" debts that the Government purportedly owes to these individuals to eliminate any liability to the Government. In other variations, individuals argue that Federal Reserve notes, or "paper money," are not legal tender and that the Government has been wrongfully using taxpayers and their labor as security for the Government's obligations. Other individuals argue that they may reclaim, or "chargeback," their own value from the Government as a result of the Government's wrongful conduct and then use that value to pay the individuals' debts. Participants in removal schemes often attempt to offset, collect or "redeem" their asserted claims against the Government by using or filing liens, bills of exchange, and various Uniform Commercial Code (UCC) forms, or by relying on misinterpretations of federal laws and the Uniform Commercial Code.

Participants in the removal schemes may rely on one or more of the following erroneous arguments, alleged facts or actions to support their frivolous claims: (a) the bankruptcy of the United States occurred contemporaneously with the creation of the Federal Reserve, the start of the Great Depression, the removal of the United States from the gold standard, or the passage of House Joint Resolution 192 (claimed to be a declaration of bankruptcy); (b) the Government's use of birth certificates of taxpayers as registered securities; (c) the filing of documents with variations on a taxpayer's name, (*e.g.*, using all capital letters in some documents and standard capitalization in others) creates a "straw man" or "nom de guerre" as the debtor to the Government that replaces the individual who has removed himself from the Government's jurisdiction; (d) the "redemption" of debts from the Government by filing UCC forms, such as the UCC-1 form; (e) the submission of documents to the U.S. Secretary of the Treasury to establish a fictitious bank account (sometimes referred to as a "Treasury Direct Account") where the value of charged back debts is located; (f) the practice of "accepting for value" official Government documents and the "charging back" of those documents by responding to them with a "private notice" that may include a "Treasury Direct Account Number," a "Memory of Account Number" or a "Posted Certified Account Number"; and (g) the use of "Bills of Exchange," Form UCC-3 and "Sight Drafts" to discharge debts to the Government. This list is not exclusive, however. Participants in removal schemes also make other equally frivolous arguments.

Instead of filing federal income tax returns with the Service, participants in removal schemes frequently send documents and other correspondence to the Service and other Government agencies. Examples of these documents include: improperly filed Forms 1040-ES, *Estimated Tax for Individuals*, reporting the location of the funds in a fictitious bank account from which the IRS can collect taxes; improperly filed Fiduciary Tax Returns; improperly filed Forms 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, reporting that a person or entity has "charged back" after "accepting for value" the Government's documents; improperly filed Forms W-9, *Request for Taxpayer Identification Number and Certification*, to obtain a social security or employee identification number of a person or entity to include on the Form 8300; "commercial affidavits" in lieu of tax returns stating that the filer is a secured party and has no income for a particular year; and documents and correspondence to "accept for value" IRS notices of tax liens and levies to have the tax balances paid from the filer's "Treasury Direct Account."

There is no authority under any U.S. law that supports the claim that individuals may avoid their federal income tax obligations based on removal arguments such as those described in this revenue ruling. Similarly, there is no authority under any U.S. law that supports the claim that requiring payment of a debt owed to the Government by commercially acceptable means amounts to a fraud by the Government. Section 61 of the Internal Revenue Code provides that gross income includes all income from whatever source derived, including compensation for services. Adjustments to income, deductions, and credits must be claimed in accordance with the provisions of the Internal Revenue Code and the Treasury regulations

thereunder and other applicable federal law. Section 6011 provides that any person liable for any tax imposed by the Internal Revenue Code shall make a return when required by Treasury regulations, and that returns must be in accordance with Treasury regulations and IRS forms. Section 6012 identifies the persons who are required to file income tax returns. Section 6151, except as specifically provided, requires that taxpayers pay their tax when the return is due. Section 6311 requires payment of taxes by commercially acceptable means as prescribed by Treasury Regulations.

Courts repeatedly have rejected removal arguments and other similar arguments as frivolous and have penalized taxpayers who make these types of arguments. *See*, *e.g.*, *United States v. Sloan*, 939 F.2d 499, 500 (7th Cir. 1991) (affirming criminal conviction for tax evasion and rejecting "wholly defective" arguments that the federal tax laws did not apply to taxpayer because he was a "freeborn, natural individual, a citizen of the State of Indiana, and a 'master' — not — 'servant' of his Government"); *United States v. Condo*, 741 F.2d 238, 239 (9th Cir. 1984) (affirming criminal conviction for tax fraud and rejecting as "frivolous" the argument that Federal Reserve Notes are not valid currency, cannot be taxed, and are merely "debts"); *United States v. Rickman*, 638 F.2d 182, 184 (10th Cir. 1980) (affirming criminal conviction for willfully failing to file a return and rejecting the taxpayer's argument that "the Federal Reserve Notes in which he was paid were not lawful money within the meaning of Art. 1, § 8, United States Constitution").

Although individuals who rely on these removal arguments generally do not file federal income tax returns with the Service, some individuals also are relying on removal or similar frivolous arguments to claim that they can reduce or eliminate their tax by filing tax returns in which they report zero income and tax liability. See Rev. Rul. 2004-34, 2004-12 I.R.B. (3/22/2004), for a discussion of this frivolous position.

CIVIL AND CRIMINAL PENALTIES

The Service will challenge the claims of individuals who attempt to avoid or evade their federal tax liability by refusing to file returns and pay tax on the basis that they have been removed or redeemed from the federal tax system. In addition to liability for the tax due plus statutory interest, individuals who fail to file and pay tax or who claim refunds based on this or any other frivolous arguments face substantial civil and criminal penalties. Potential civil penalties include: (1) the section 6651(f) penalty for fraudulent failure to file, which is up to 75 percent of the amount of taxes the taxpayer should have reported on the return ; (2) the section 6651(a)(1) penalty for failure to file, which is equal to up to 25 percent of the amount of taxes the taxpayer should have reported on the return; (3) the section 6651(a)(2) penalty for failure to pay, which is equal to .5 percent of the tax for each month or fraction of a month the tax remains unpaid, not to exceed a total of 25 percent; and; (4) a penalty of up to $25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Individuals relying on this scheme also may face criminal prosecution for: (1) attempting to evade or defeat tax under section 7201 for which the penalty is a fine of up to $100,000 and imprisonment for up to 5 years; (2) willful failure to make a return or pay tax under section 7203 for which the penalty is up to $25,000 and imprisonment of up to 1 year, or (3) making false statements under section 7206 for which the penalty is a fine of up to $100,000 and imprisonment for up to 3 years.

Persons who promote this scheme and those who assist taxpayers in claiming tax benefits based on this scheme also may face penalties. Potential penalties include: (1) a $250 penalty under section 6694 for each return prepared by an income tax return preparer who knew or should have known that the taxpayer's argument was frivolous (or $1,000 for each return where the return preparer's actions were willful, intentional or reckless); (2) a $1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (3) criminal prosecution under section 7206 for which the penalty is a fine of up to $100,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

HOLDING

Individuals may not avoid or evade their tax liability by refusing to file returns and pay tax on the basis that they have been removed or redeemed from the federal tax system or by claiming that they can "chargeback" their debts to the Government. Arguments that individuals may be removed or redeemed from the federal tax system or may "chargeback" their debts to the Government have no merit and are frivolous. Individuals who attempt to reduce their federal tax liability by taking frivolous positions based on these arguments will be liable for the actual tax due plus statutory interest. In addition, the Service will determine civil penalties against individuals where appropriate, and those individuals may also face criminal prosecution. The Service also will determine appropriate civil penalties against persons who prepare frivolous returns or promote frivolous positions, and those persons may also face criminal prosecution. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622-4940 (not a toll-free call).

REVENUE PROCEDURE 2002-69

Internal Revenue Service (IRS)
Revenue Procedure (Rev. Proc.)
Released: October 9, 2002
Classification of certain business entities
(Also Section 301.7701-2.)

This procedure provides guidance on the classification for federal tax purposes of a qualified entity (described in section 3.02 of this procedure) that is owned solely by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States.

SECTION 1. PURPOSE

The Treasury Department and the Internal Revenue Service have become aware that taxpayers are unsure of the classification for an entity that is owned solely by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States. To alleviate this uncertainty and in the interest of administrative simplicity, this revenue procedure provides that the Internal Revenue Service will respect a taxpayer's treatment of these entities as either disregarded entities or partnerships.

This revenue procedure provides guidance on the classification for federal tax purposes of a qualified entity (described in section 3.02 of this revenue procedure) that is owned solely by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States.

SECTION 2. BACKGROUND

Section 301.7701-1(a)(1) states that the Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-1(b) provides that the classification of organizations that are recognized as separate entities is determined under Sections 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Code provides for special treatment of that organization.

Section 301.7701-2(a) defines the term “business entity” as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Section 301.7701-3) that is not properly classified as a trust under Section 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

SECTION 3. SCOPE

.01 In General

This revenue procedure provides guidance on the classification for federal tax purposes of a qualified entity (described in section 3.02 of this revenue procedure).

.02 Qualified Entity

A business entity is a qualified entity if:

(1) The business entity is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States;

(2) No person other than one or both spouses would be considered an owner for federal tax purposes; and

(3) The business entity is not treated as a corporation under Section 301.7701-2.

SECTION 4. APPLICATION

.01 If a qualified entity (as described in section 3.02 of this revenue procedure), and the husband and wife as community property owners, treat the entity as a disregarded entity for federal tax purposes, the Internal Revenue Service will accept the position that the entity is a disregarded entity for federal tax purposes.

.02 If a qualified entity (as described in section 3.02 of this revenue procedure), and the husband and wife as community property owners, treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the Internal Revenue Service will accept the position that the entity is a partnership for federal tax purposes.

.03 A change in reporting position will be treated for federal tax purposes as a conversion of the entity.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective on the date published in the Internal Revenue Bulletin.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Laura Nash of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Nash or Ms. Rebekah Myers at (202) 622-3050 (not a toll-free call).

PRIVATE LETTER RULING 200131014

Date: May 2, 2001
Refer Reply To: CC:IT&A:5 PLR-131306-00

LEGEND:

Taxpayer = ***
State W = ***
State X = ***
State Y = ***
State Z = ***
State Y RP = ***
State Z RP = ***
Year 1 = ***
Year 2 = ***
x = ***
a, b, and c = ***
y = ***
z = ***
Date 1 = ***
Date 2 = ***
Date 3 = ***
Date 4 = ***
Date 5 = ***
$A = ***

Dear ***

This responds to Taxpayer's letter, dated December 11, 2000, requesting a private letter ruling as to the application of section 1031 of the Internal Revenue Code ("Code") to the proposed transaction. Specifically, Taxpayer requests rulings that the transfer of replacement property received in a like-kind exchange to a single-member limited liability company (LLC) will not violate the requirement under section 1031(a)(1) of the Code that Taxpayer's replacement property must be held for productive use in a trade or business or for investment after the exchange. These are the applicable facts:

Taxpayer, a State W corporation which has elected to be taxed under subchapter S of the Code, uses the cash method of accounting for maintaining its books and preparing its federal income tax returns. With the consent of the Service, Taxpayer uses an accounting period ending on the thirtieth day of April.

Taxpayer was first organized in Year 1 as a cattle operation. Initially, its assets included x acres of pasture and agricultural land in State W. However, to remain economically viable it has gradually diversified its activities, spreading out the inherent risks of weather, crop variation and commodity pricing. Thus, over the past several years it has engaged in the businesses of a, b, and c. In addition to these various enterprises, Taxpayer purchased a y acre steer-grazing ranch in State X in Year 2.

On Date 1, Taxpayer entered into contract to sell certain unencumbered real property consisting of z acres of land located in State W (the relinquished property or RQ) for $A. Taxpayer entered into this contract intending to exchange the relinquished property for like-kind replacement property in a transaction that would qualify as a deferred like-kind exchange under section 1031(a)(3) of the Code. On Date 2, Taxpayer executed exchange and escrow agreements with a "qualified intermediary," as that term is defined in section 1.1031(k)-1(g)(4)(iii) of the Income Tax Regulations (hereinafter, "QI"). These agreements prohibited Taxpayer from actually or constructively receiving money or property arising from the transfer of RQ, other than properly identified, like-kind property, prior to the occurrence of the events specified in section 1.1031(k)-1(f) and (g). The escrow and exchange agreements were drafted to meet the requirements set forth in section 1.1031(k)-1.

On Date 3, Taxpayer assigned its rights in the contract of sale of RQ (as amended) to QI and gave written notice of this assignment to the purchaser. At the closing, RQ was deeded directly to the purchaser and all sales proceeds were paid to QI, who deposited the proceeds into a "qualified escrow account" within the meaning of section 1.1031(k)-1(g)(3)(ii). The transfer of RQ was effectuated in a manner that met all the requirements of sections 1.1031(k)-1(g)(4)(iv)(B) and 1.1031(k)-1(g)(8) Example 4.

Within 45 days after the date on which Taxpayer transferred RQ, Taxpayer identified four replacement properties the aggregate fair market value of which as of the end of the identification period did not exceed 200 percent of [t] he aggregate fair market value of RQ as of the date RQ was transferred by Taxpayer. The identification was in writing, was sent to QI, and unambiguously described the possible replacement properties. Taxpayer met all of the requirements for the identification of replacement property set forth in section 1.1031(k)-1(c).

On Date 4, Taxpayer assigned its rights under a certain agreement to acquire a hotel property located at State Y (one of the properly identified replacement properties and hereinafter referred to as "State Y RP") to QI. Prior to the assignment, Taxpayer gave written notice to the seller of the State Y RP that it was assigning its rights under the agreement of purchase and sale to QI. Before 180 days after the date on which Taxpayer transferred RQ (and before the due date of Taxpayer's federal income tax return for the year in which the transfer of RQ occurred) QI transferred funds from the qualified escrow account to the seller of the State Y RP. The State Y RP was deeded directly to Taxpayer. The assignment, notice,

transfer of funds from escrow, and direct deeding with respect to the State Y RP were all completed in a manner that strictly complied with the requirements of sections 1.1031(k)-1(g)(4)(iv)(C) and 1.1031(k)-1(g)(8) Example 4.

On Date 5, Taxpayer assigned its rights under a certain agreement to acquire a hotel property located at State Z (one of the properly identified replacement properties and hereinafter referred to as State Z RP) to QI. Prior to the assignment, Taxpayer gave written notice to the seller of the State Z RP that it was assigning its rights under the agreement of purchase and sale to QI. Before 180 days after the date on which Taxpayer transferred RQ (and before the due date of Taxpayer's federal income tax return for the year in which the transfer of RQ took place) the QI transferred funds from the qualified escrow account to the seller of the State Z RP. The State Z RP was deeded directly to Taxpayer. The assignment, notice, transfer of funds from escrow, and direct deeding with respect to the State Z RP were all completed in a manner that strictly complied with the requirements of sections 1.1031(k)-1(g)(4)(iv)(C) and 1.1031(k)-1(g)(8) Example 4.

All proceeds from RQ were reinvested in the State Y RP and State Z RP. Taxpayer holds State Y RP and State Z RP for use in its trade or business or for investment.

The hotel businesses operated on these replacement properties are subject to significant and unique liability risks that can best be managed by holding the properties on which they operate in separate single-asset entities. In addition, to satisfy the post- exchange business requirements of the replacement properties, and certain other businesses of Taxpayer, Taxpayer will borrow money using the replacement properties as collateral. The prospective lenders will require each of the replacement properties be held in single-asset entities as a condition to making the necessary loans. To protect its other assets from the risks associated with owning State Y RP and State Z RP and to meet the prospective lenders' requirement that each replacement property be held in a single-asset entity, Taxpayer desires to transfer each replacement property to a separate, wholly-owned State Y limited liability company (State Y LLC). Both State Y LLCs will either elect to be disregarded as entities separate from their owner or will rely on the default classification rule for single-owner entities under section 301.7701- 3(b)(1)(ii). The borrowing will occur in a taxable year subsequent to the taxable year of the exchange. Proceeds from the loan(s) will be used exclusively to advance Taxpayer's business objectives.

Section 1031(a)(1) of the Code provides that no gain or loss will be 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 a like kind which is to be held either for productive use in a trade or business or for investment. Under section 1.1031(a)-1(b) of the regulations relating to the meaning of the term “like kind,” real property is generally considered to be of like kind to all other real property, whether or not any of the real property involved is improved.

In Rev. Rul. 75-292, 1975-2 C.B. 333, a like-kind exchange of real estate between a taxpayer and an unrelated party was followed by the immediate transfer of the replacement property by the taxpayer to a corporation. This corporation was formed by the taxpayer. The taxpayer exchanged the newly acquired replacement property for the stock of the same corporation in a transaction that qualified for nonrecognition of gain under section 351 of the Code. In the revenue ruling, the Service concluded that the taxpayer did not exchange the real estate for other real estate to be held either for productive use in a trade or business or for investment. Instead, the Service concluded that the replacement property was acquired for the purpose of transferring it to the new corporation, and was not to be held by the taxpayer. As a result, the Service decided, as to that taxpayer, the exchange did not qualify for nonrecognition under section 1031 of the code. See also Rev. Rul. 77-297, 1977-2 C.B. 304; and Rev. Rul. 77-337, 1977-2 C.B. 305.

Under section 301.7701-3(b)(1)(ii), a domestic eligible entity is generally (with exceptions noted) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-2(c)(2) provides that, in general, a business entity that has a single owner and is not a corporation (as defined in section 301.7701-2(b)) is disregarded as an entity separate from its owner for federal tax purposes.

In its original submission, Taxpayer expressed concerned that the transfer of the each replacement property to a separate wholly-owned State Y limited liability company would violate the holding requirement as applied in Rev. Rul. 75-292. In the present case, however, the transfer by Taxpayer of replacement property to its wholly-owned, single-member LLC will be disregarded and Taxpayer will still be considered the direct owner of such property for federal income tax purposes.

Therefore, based on the facts presented above, we rule as follows:

1. The anticipated transfer by Taxpayer of the State Y RP to a single-member, State Y limited liability company, the sole member of which will be Taxpayer, and which will either elect to be disregarded as an entity or will rely upon the default classification rule for single-owner entities under section 301.7701-3(b)(1)(ii), will not violate the requirement under section 1031(a)(1) of the Code that Taxpayer's replacement property be held for productive use in a trade or business or for investment.

2. The anticipated transfer by Taxpayer of the State Z RP to a single-member, State Y limited liability company, the sole member of which will be Taxpayer, and which will either elect to be disregarded as an entity or will rely upon the default classification rule for single-owner entities under section 301.7701-3(b)(1)(ii), will not violate the requirement under section 1031(a)(1) of the Code that Taxpayer's replacement property be held for productive use in a trade or business or for investment.

No determination is made by this letter whether the described transaction otherwise qualifies for deferral of gain realized under section 1031. We express no opinion, except as specifically ruled above, as to the federal tax treatment of the transaction under any other provisions of the Code and regulations that may be applicable or under any other general principles of federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction(s) that are not specifically covered by the above ruling.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.

Sincerely yours,

Associate Chief Counsel
(Income Tax & Accounting)
By: Robert M. Casey
Senior Technician Reviewer,
Branch 5

PRIVATE LETTER RULING 200118023

Date: January 31, 2001
Refer Reply To: CC:DOM:IT&A:5 PLR-114061-00

LEGEND:

Taxpayer = ***
XX = ***
QI = ***
State X = ***
RQ = ***
RP = ***

Dear ***

This responds to Taxpayer's letter, dated July 19, 2000, and a supplemental submission dated August 24, 2000, requesting a private letter ruling as to the application of section 1031 of the Internal Revenue Code ("Code") to the proposed transaction. Specifically, Taxpayer requests a ruling that acquisition of an exchange accommodator (QI), which, as an LLC, is a disregarded business entity for federal tax purposes, will be treated as the acquisition of qualifying like-kind replacement property.

QI is a single member LLC organized under the laws of State X. It has not elected to be classified as an association pursuant to section 301.7701-3(c) of the Procedure and Administration Regulations. Its sole member is XX. To facilitate an exchange with Taxpayer of RQ for RP, QI acquired RP. RP consists of real property selected by Taxpayer, on which XX constructed improvements to Taxpayer's specifications. The conveyance of RP to Taxpayer would be subject to a real estate transfer fee under State X law. However, the transfer of the ownership interest in an LLC, such as QI, to Taxpayer would not be subject to the real estate transfer fee. To avoid incurring a liability for the local real estate transfer fees incident to the transfer of RP by QI, Taxpayer proposes to simply acquire QI from XX.

Section 301.7701-2(c)(2) provides that, in general, a business entity that has a single owner and is not a corporation (as defined in section 301.7701-2(b)) is disregarded as an entity separate from its owner for federal tax purposes unless the entity elects to treat itself as an association for federal tax purposes. Because QI, as an LLC, will be disregarded as an entity separate from its owner, the receipt of the ownership of QI by Taxpayer is treated as the receipt by Taxpayer of RP owned by QI.

Accordingly, Taxpayer's receipt of the sole ownership interest in QI, which owns RP, will be treated as the receipt of RP directly by Taxpayer for purposes of qualifying the receipt of such RP for nonrecognition of gain under section 1031.
The above ruling applies only to the extent property held by QI at the time it is transferred to Taxpayer is property of a like kind to RQ, to be held for use in Taxpayer's trade or business or for investment. Non-like-kind property held by QI, if any, will be taxable to Taxpayer as boot. In addition, any other (non-like-kind) property transferred to Taxpayer, incident to this exchange, will be taxable boot to Taxpayer, regardless of whether Taxpayer first receives the ownership interest in QI. No determination is made by this letter as to whether the described transaction otherwise qualifies for deferral of gain realized under section 1031.

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. No opinion is expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling. This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.

Sincerely yours,

Assistant Chief Counsel
(Income Tax & Accounting)
By: Robert M. Casey
Senior Technician Reviewer,
Branch 5

PRIVATE LETTER RULING 199911033

Date: December 18, 1999
Refer Reply To: CC:DOM:P&SI:Br.1-PLR-116853-98

LEGEND:

Trust = ***
A = ***
Date1 = ***
Date2 = ***
Intermediary = ***
Lender = ***
State = ***
Member2 = ***

Dear ***

This responds to a letter dated November 10, 1998, and prior correspondence submitted on behalf of Trust and requesting rulings under sections 1031 and 7701 of the Internal Revenue Code.

FACTS

You have represented the facts as follows. A is the grantor of Trust. Under section 671, all of the income, deductions, and credits against tax of the trust are treated as those of A for purposes of computing A's taxable income. On Date1, the trustees of Trust assigned all of their rights in a contract to sell a parcel of real estate (the Relinquished Property) to Intermediary pursuant to an exchange agreement dated Date1. Intermediary is a "qualified intermediary" as defined in section 1.1031-1(g)(4) of the Income Tax Regulations. As required by those regulations, notice of the assignment was given to the buyer on Date2.

As contemplated by the exchange agreement, Intermediary will acquire like-kind property (the Replacement Property), and transfer it to Trust. The intent of the parties is that the transfer of the Relinquished Property and the receipt of the Replacement Property will constitute a nontaxable deferred exchange under section 1031(a)(3). Consistent with the requirements of that section, Trust identified the Replacement Property that it will acquire by Date3.

The Replacement Property will be financed by Lender. Lender insists that legal title to the Replacement Property be held by a bankruptcy remote entity. To satisfy this requirement, Trust will form a State limited liability company (LLC) pursuant to a limited liability company agreement (the Agreement) between the Trustees and Member2, a corporation wholly owned by Trust. To protect the Lender's interest, one of the members of the Board of Directors of Member2 will be a representative of Lender. The Replacement Property will be transferred directly to LLC.

Except as otherwise provided in section 7.1 of the Agreement, all decisions of the LLC will be made solely by Trust. Under section 7.1, for so long as the loan from Lender is, outstanding without the approval of Member 2 (whose Board of Directors vote must be unanimous) the LLC may not: (1) file or consent to the filing of a bankruptcy or insolvency petition or otherwise institute insolvency proceedings; (2) dissolve, liquidate, merge, consolidate, or sell substantially all of its assets; (3) engage in any business activity other than those specified in its Certificate of Formation; (4) borrow money or incur indebtedness other than the normal trade accounts payable and any other indebtedness expressly permitted by the documents evidencing and securing the loan from Lender; (5) take or permit any action that would violate any provision of any of the documents evidencing or securing the loan from Lender; (6) amend the Certificate of Formation concerning any of the aforesaid items; or (7) amend any provision of the Agreement concerning any of the aforesaid items. With respect to items 2 and 7, the LLC must have the prior written consent of the Lender.

With the exception of the rights contained in section 7.1, Member2 has no other rights relating to the management of the LLC. Section 5 of the Agreement provides that all profits, losses, and credits of the LLC will be allocated to Trust. In addition, all distributions of net cash flow and capital proceeds will be made entirely to Trust. Furthermore, upon the dissolution of LLC, Trust will wind up the affairs of LLC in any manner permitted or required by law, provided that the payment of any outstanding obligations owed to Lender will have priority over all other expenses or liabilities.

RULINGS REQUESTED

Based on these facts and representations, you have requested that we rule as follows:

(1) The LLC will be treated as having a single owner for purposes of sections 301.7701-2(c)(2) and 301.7701-3 and, in the absence of any election to the contrary, will be disregarded as an entity separate from its owner; and

(2) The acquisition of Replacement Property by the LLC will be treated as a direct acquisition by Trust for purposes of section 1031(a)(3).

LAW AND ANALYSIS

Section 301.7701-2(a) of the Procedure and Administration Regulations provides that business entities are entities recognized for federal tax purposes but not properly classified as trusts under section 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or

more members is classified for federal tax purposes as either a partnership or a corporation. Under section 301.7701-3(b)(1)(i), a domestic eligible entity (as defined in section 301.7701-3(a)) will be treated as a partnership unless it elects to be treated as a corporation. A business entity with only one owner is classified as a corporation or is disregarded as an entity separate from its owner. Under section 301.7701- 3(b)(1)(ii), a domestic eligible entity with a single owner is disregarded as an entity separate from its owner unless it elects to be treated as a corporation under section 301.7701-3(c).

Since LLC is a domestic eligible entity and you have represented that it will not file an election to be treated as a corporation, its federal tax classification depends upon the number of members of LLC. The cases of Commissioner v. Tower, 327 U.S. 280 (1946) and Commissioner v. Culbertson, 337 U.S. 733 (1949), provide general principles regarding the determination of whether individuals have joined together as partners in a partnership. The primary inquiry is whether the parties had the intent to join together to operate a business and share in its profits and losses. The inquiry is essentially factual and all relevant facts and circumstances must be examined. Furthermore, it is federal, not state, law that controls for income tax purposes, regardless of how the parties are treated under state law.

In Herbert M. Luna, 42 T.C. 1067, 1077 (1964), the court stated that the following factors should be considered in determining whether the parties intended to be a partnership: (1) the agreement of the parties and their conduct in executing its terms; (2) whether business was conducted in the joint names of the parties; (3) whether the parties filed Federal partnership returns or otherwise represented to the Service or to persons with whom they dealt that they were joint venturers; (4) whether separate books of account were maintained for the venture; (5) the contributions, if any, which each party has made to the venture; (6) whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; (7) the parties' control over income and capital and the right of each to make withdrawals; and (8) whether the parties exercised mutual control over and assumed mutual responsibility for the enterprise.

In this case, the members of LLC have not come together to form a partnership for federal tax purposes because, as evidenced by the LLC agreement, Trust and Member2 did not enter into the Agreement to operate a business and share profits and losses. Member2 is a member of LLC for the sole limited purpose of preventing Trust from placing LLC into bankruptcy on its own volition. Member2 has no interest in LLC's profits or losses and neither manages the enterprise nor has any management rights other than those limited rights described above. Thus, for federal tax purposes LLC will not be treated as a partnership between Trust and Member2 but rather as being owned solely by Trust. Because Trust is the sole owner of LLC and LLC will not elect to be treated as a corporation for federal tax purposes, LLC will be disregarded as an entity separate from Trust. Accordingly, the transfer of Replacement Property to LLC will be treated as a transfer of the Replacement Property to Trust for purposes of section 1031(a)(3).

CONCLUSION

Based on the facts submitted and the representations made, we rule as follows:

(1) Provided that LLC does not file an election to be treated as a corporation for federal tax purposes under section 301.7701-3(c), LLC will be disregarded as an entity separate from Trust; and

(2) The acquisition of Replacement Property by LLC will be treated as a direct acquisition by Trust for purposes of section 1031(a)(3).

Except as specifically ruled on above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provisions of the Code. In particular, no opinion is expressed concerning whether the transaction described above otherwise meets the requirements for nonrecognition of gain treatment under section 1031.

This ruling is directed only to the taxpayer requesting it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

DIANNA K. MIOSI
Chief, Branch 1
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

PRIVATE LETTER RULING 9850001

Date: August 31, 1998
Refer Reply To: CC:DOM:IT&A:5 PLR-109062-98

LEGEND:

Taxpayer = ***
P = ***
H = ***
S = ***
LLC1 = ***
LLC2 = ***
W = ***
Date 1 = ***
Date 2 = ***
Date 3 = ***

Dear ***

This responds to Taxpayer's request for a private letter ruling dated April 8, 1998, as amended by correspondence dated May 20, 1998, June 15, 1998, and August 26, 1998. Taxpayer represents the following facts:

P, a foreign corporation, owns, directly or indirectly, 95% of H, a U.S. holding company, which owns all the outstanding stock of Taxpayer, a U.S. operating company. H and Taxpayer file a U.S. consolidated return on the basis of a calendar year. P also owns, directly or indirectly 95% of the stock of S, a U.S. operating company. S is the sole owner of LLC1, a limited liability company that has not elected pursuant to section 301.7701 of the Regulations on Procedure and Administration to be classified as an association. LLC1 holds an interest in hotel property.

Taxpayer held hotel property for productive use in a trade or business (the relinquished property). On Date 1, Taxpayer transferred the hotel property to a qualified intermediary, pursuant to section 1.1031(k)-1(g)(4) of the Income Tax Regulations.[1] The qualified intermediary then transferred the property to W. On Date 2 (within 45 days after the transfer by Taxpayer of the relinquished property), Taxpayer identified like kind replacement property in accordance with section 1031(a)(3)(A) of the Internal Revenue Code.

After the transfer of the relinquished property, but prior to receipt of the replacement property, Taxpayer formed LLC2, a wholly-owned limited liability company that did not elect to be treated as an association pursuant to section 301.7701 of the regulations. Taxpayer directed that the replacement property be transferred to LLC2. On Date 3 (within 180 days after the transfer by Taxpayer of the relinquished property and before the due date of Taxpayer's return for the year of transfer), LLC2 received the replacement property for use in its trade or business.

At some time after receipt of the replacement property by LLC2, Taxpayer will liquidate into H. The liquidation will qualify for nonrecognition of gain or loss under section 332 of the Code. H will then merge with S. The merger of H with S will qualify as a corporate reorganization under section 368(a)(1)(A) of the Code.
As a result of the merger of H with S, S will be the sole owner of LLC1 and LLC2. S will then transfer its interest in LLC2 to LLC1 and both entities will continue in existence.

Under these facts, Taxpayer requests a ruling that the liquidation of Taxpayer into H, and the merger of H into S will not affect the requirement under section 1031(a)(1) that the replacement property be held by Taxpayer either for the productive use in a trade or business or for investment. Taxpayer also requests a ruling that the transfer by S of S's interest in LLC2 to LLC1 will not adversely affect the section 1031 exchange involving the relinquished property and the replacement property.

Section 1031(a)(1) of the Code provides that no gain or loss will be 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 a like kind which is to be held either for productive use in a trade or business or for investment. Under section 1.1031(a)-1(b) of the regulations relating to the meaning of the term “like kind,” real property is generally considered to be of like kind to all other real property, whether or not any of the real property involved is improved. However, under section 1031(a)(3), any property received by the taxpayer (the “replacement property”) will be treated as if it is not of a like kind to the property transferred (the “relinquished property”) if the replacement property (a) is not identified within 45 days of the taxpayer's transfer of the relinquished property, or (b) is received after the earlier of (i) 180 days after the taxpayer's transfer, or (ii) the due date of the taxpayer's return for the year in which the taxpayer's transfer occurred.

Section 381(a) of the Code provides that, in the case of the acquisition of assets of a corporation by another corporation — (1) in a distribution to such corporation to which section 332 (relating to liquidations of subsidiaries) applies; or (2) in a transfer in which section 361 applies (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F) or (G) of section 368(a)(1), the acquiring corporation shall succeed to and take into account as of the close of the day of distribution or transfer, the items of the distributor or transferor corporation described in section 381(c) subject to certain conditions and limitations.

Section 332(a) of the Code generally provides that no gain or loss shall be recognized on receipt by a corporation of property distributed in complete liquidation of another corporation.

Section 368(a)(1)(A) of the Code provides that the term "reorganization" includes a statutory merger or consolidation.

Section 1.381(a)-1(b)(3)(i) of the regulations provides, in part, that section 381 does not apply to the carryover of an item or tax attribute not specified in section 381(c) of the Code. Section 381(c) does not refer to like kind exchanges under section 1031 of the Code. However, the legislative history of section 381 explains that "[T]he section is not intended to affect the carryover treatment of an item or tax attribute not specified in the section or the carryover treatment of items or tax attributes in corporate transactions not described in subsection (a). No inference is to be drawn from the enactment of this section whether any item or tax attribute may be utilized by a successor or predecessor corporation under existing law." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A135 (1954). See also section 1.381(a)-1(b)(3)(i) of the regulations (to the same effect). In other words, Congress did not intend the tax attributes listed in section 381(c) of the Code to be the exclusive list of attributes available for carryover. The legislative history further reveals that the purpose of section 381 is to put into practice the policy that "economic realities rather than ...such artificialities as the legal form of the reorganization" ought to control in the question of whether a tax attribute from an acquired corporation is to be carried over to the acquiring one. Section 381 was enacted "to enable the successor corporation to step into the "tax shoes" of its predecessor corporation without necessarily conforming to artificial legal requirements which [then existed at the time of its enactment] under court-made law." See S. Rep. No. 1622, 83rd Cong., 2d Sess. 52 (1954).

The special treatment of like kind exchanges under section 1031 of the Code has been explained primarily on two grounds. First, a taxpayer making a like kind exchange has received property similar to the property relinquished and therefore has not "cashed out" of the investment in the relinquished property. In addition, administrative problems may arise with respect to valuing property which is exchanged solely or primarily for similar property. See, e.g., Staff of the Joint Committee of Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 244-5 (1984); Starker v. United States, 602 F.2d 1341, 1352 (9th Cir. 1979). These concerns are equally applicable when, as a result of a liquidation under section 332 or a reorganization under section 368(a)(1)(A), a successor corporation obtains ownership of like kind property previously received by a liquidated or an acquired corporation in a transaction to which section 1031 applies. Accordingly, we conclude that for purposes of section 1031(a)(1) there is a carryover of tax attributes following both a section 332 liquidation and a section 368(a)(1)(A) reorganization. Thus, the intervening liquidation and reorganization, under the facts of this case, will not affect whether the replacement property is held for productive use in a trade or business or for investment.

Section 301.7701-2(c)(2) of the regulations provides that, in general, a business entity that has a single owner and is not a corporation (as defined in section 301.7701-2(b)) is disregarded as an entity separate from its owner for federal tax purposes unless the entity elects to treat itself as an association for federal tax purposes. Because LLC1 and LLC2 each will be disregarded as an entity separate from its owner for federal tax purposes, the assets of each wholly-owned LLC will be treated as assets of its owner.

Based on the facts presented above, we rule that:

> (1) The liquidation of Taxpayer into H, and the merger of H into S, will have no affect on the requirement under section 1031(a)(1) that the replacement property be held [by Taxpayer] either for the productive use in a trade or business or for investment.
>
> (2) The transfer by S of its interest in LLC2 to LLC1 will have no affect on the section 1031 exchange of the relinquished property and the replacement property.

No opinion is expressed as to the application of any other provision of the Code or the regulations to the transaction at issue or as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction described which are not specifically covered in the above ruling. In particular, we express no opinion on whether the liquidation of Taxpayer into H will qualify under section 332 of the Code or whether the merger of H into S qualifies as a reorganization described under section 368(a)(1)(A).

A copy of this letter should be attached to the federal income tax return for the year in which the transaction in question occurs. This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be cited as precedent.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)
By: Kelly E. Alton
Senior Technician Reviewer,
Branch 5

PRIVATE LETTER RULING 9807013

Date: November 13, 1997

Refer Reply to: CC:DOM:ITA:05 PLR-109877-97

LEGEND:

Taxpayer = ***
Taxpayer's EIN = ***
Taxpayer's Address = ***
Year Involved = ***
State A = ***
State B = ***
LLC = ***
GP = ***

Dear ***

This letter responds to your request for a private letter ruling, dated May 16, 1997, submitted on behalf of Taxpayer. Taxpayer, a State A limited partnership, requests a ruling that the receipt of several parcels of real property (each parcel is a "Replacement Property", collectively, the parcels are the "Replacement Properties") by an entity owned by Taxpayer will be treated as the receipt of real property directly by the Taxpayer for purposes of qualifying the receipt of such Replacement Property for nonrecognition of gain under section 1031 of the Code.

Facts

Taxpayer, a State A limited partnership, uses the accrual method for maintaining its accounting books and for preparing its federal income tax returns. The Taxpayer's taxable year ends on December 31. The Taxpayer's partners are LLC, a State A limited liability company, and GP, a general partnership organized in State B.

Taxpayer's business operations consist of the ownership and leasing of a single parcel of improved land. The improvements to the land consist of a commercial office building and related structures. The land and improvements are leased to a single lessee under a long-term lease. Collectively, the land and building are referred to as the "Relinquished Property".

The Relinquished Property serves as security for the Taxpayer's indebtedness. Under the terms of the indebtedness, Taxpayer is required to hold only the Relinquished Property.

Taxpayer has determined that it is in its partners' best interests to dispose of the Relinquished Property. Taxpayer has identified a party interested in acquiring the Relinquished Property. Each Replacement Property will be subject to indebtedness ("Replacement Indebtedness") secured by that Replacement Property. Taxpayer wishes to acquire each Replacement Property subject to its Replacement indebtedness. The terms of each Replacement Indebtedness require that, for such indebtedness to be taken subject to as part of an exchange, the Replacement property securing such Replacement Indebtedness must be acquired by a single asset entity.

Taxpayer proposes to achieve its business objectives by engaging in the following actions:

(1) Taxpayer will transfer title to the Relinquished property directly to a qualified intermediary (within the meaning of section 1.1031(k)-1(g)(4) of the Income Tax Regulations).

(2) Taxpayer will form a separate entity (a "Replacement Entity") to take title to each Replacement Property to be received in the exchange. Accordingly, Taxpayer will form one such entity for each of the Replacement Properties.

(3) Each Replacement Entity will receive title to its designated Replacement Property directly from the qualified intermediary as part of the overall exchange.

(4) Each Replacement Entity will be a "business entity" that is a "domestic eligible entity" within the meaning of section 301.7701-2 and 3 of the regulations.

(5) Taxpayer will be the sole owner of the ownership interests in each Replacement Entity.

(6) Each Replacement Entity will either: (i) file a timely and proper election to be disregarded as an entity separate from its owner pursuant to section 301.7701-3 of the regulations, or (ii) will not file any election pursuant to section 301.7701-3(c) regarding its classification and will instead rely on the default classification rule for single owner entities pursuant to section 301.7701-3(b)(1)(ii).

(7) Each Replacement Entity will hold its Replacement Property either for productive use in a trade or business or for investment, in each case, within the meaning of section 1031 of the Code.

(8) Neither Taxpayer nor any Replacement Entity will be a bank as defined in section 581 of the code.

(9) Taxpayer has represented that the exchange of the Relinquished Property for the Replacement properties will comply with the requirements of section 1.1031(k)-1 of the regulations relating to the qualification of such exchange for nonrecognition of gain or loss under section 1031(a) of the Code.

Law and Analysis

Section 1031(a)(2) of the Code provides 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(a)(2) excludes from eligibility for nonrecognition treatment any exchange of interests in a partnership, stock, or certification of trust or beneficial interest.

Section 301.7701-2(c)(2) of the regulations provides that, in general, a business entity that has a single owner and is not a corporation (as defined in section 301.7701-2(b)) is disregarded as an entity separate from its owner for federal tax purposes unless the entity elects to treat itself as an association for federal tax purposes. Because each Replacement Entity will be disregarded as an entity separate from its owner for federal tax purposes, the assets of each Replacement Entity will be treated as assets of the Taxpayer.

Conclusion

Taxpayer's receipt of the Replacement Properties by the Replacement Entities will be treated as the receipt of real property directly by the Taxpayer for purposes of qualifying the receipt of such Replacement Property for nonrecognition of gain under section 1031 of the code.

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the above transactions under other provisions of the code and regulations that may be applicable. No opinion is expressed as to the tax treatment of any conditions existing at the time of or effects resulting from the transaction that are not specifically covered by the above ruling. A copy of this letter ruling should be attached to the appropriate federal income tax returns for the taxable years in which the transactions described herein are consummated.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

PRIVATE LETTER RULING 9751012

Date: September 15, 1997
Refer Reply To: CC:DOM:IT&A:5 PLR-108506-97

LEGEND:

P = ***
X = ***
Taxpayer = ***
S1 = ***
S2 = ***
W = ***
Date 1 = ***
Date 2 = ***
Date 3 = ***
State = ***

Dear ***

This responds to Taxpayer's application for a private letter ruling dated April 29, 1997. Taxpayer represents the following facts:

P, a foreign corporation, owns the majority of the outstanding stock of Taxpayer, a U.S. holding company, and X, a U.S. operating company. Taxpayer owns all the outstanding stock of S1 and S2. Taxpayer, S1 and S2 (as a consolidated group) and X all file U.S. tax returns on a calendar year basis. X, S1 and S2 each held hotel property for productive use in a trade or business (the relinquished properties).

On Date 1, X, S1 and S2 transferred their respective hotel properties to a qualified intermediary, pursuant to section 1.1031(k)-1(g)(4) of the Income Tax Regulations.[1] The qualified intermediary then transferred the said relinquished properties to W.

On or before Date 2 (within 45 days after the transfer by S1, S2 and X of their relinquished properties), S1, S2 and X identified replacement properties in accordance with section 1031(a)(3)(A) of the Internal Revenue Code. The identified replacement properties are of like kind for purposes of section 1031.

Before acquiring the replacement property, S1 and S2 will liquidate and X will merge with Taxpayer. The liquidations of S1 and S2 into Taxpayer will qualify for nonrecognition of gain or loss under section 332 of the Code. The merger of X with Taxpayer will qualify as a corporate reorganization under section 368(a)(1)(A) of the Code.

Following the liquidations of S1 and S2 into Taxpayer and the merger of X with Taxpayer, Taxpayer will form a separate limited liability company (LLC), under the laws of State, for each replacement property and will receive in each case the entire LLC ownership interest. These single-owner LLCs will not elect pursuant to section 301.7701 of the regulations to be classified as associations.

Subsequent to the formation of the LLCs and on or before Date 3,[2] the LLCs organized by Taxpayer will each receive one of the identified like-kind replacement properties. The receipt of the replacement properties by the LLCs will complete the deferred exchange transaction which began with the transfer of the relinquished properties by S1, S2 and X on Date 1.

Under these facts, Taxpayer requests a ruling that it will be treated as both the transferor of the relinquished properties and the transferee of the replacement property or properties for purposes of section 1031(a) of the Code. In addition, Taxpayer also requests a ruling that the acquisition of each replacement property by a separate LLC that is wholly owned by Taxpayer will be deemed an acquisition by Taxpayer and will not violate the requirement under section 1031(a)(1) of the Code that the like-kind replacement property is to be held for productive use in a trade or business or for investment.

Section 1031(a)(1) of the Code provides that no gain or loss will be 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 a like kind which is to be held either for productive use in a trade or business or for investment. Under section 1.1031(a)-1(b) of the regulations relating to the meaning of the term “like kind,” real property is generally considered to be of like kind to all other real property, whether or not any of the real property involved is improved. However, under section 1031(a)(3), any property received by the taxpayer (the “replacement property”) will be treated as if it is not of a like kind to the property transferred (the “relinquished property”) if the replacement property (a) is not identified within 45 days of the taxpayer's transfer of the relinquished property, or (b) is received after the earlier of (i) 180 days after the taxpayer's transfer, or (ii) the due date of the taxpayer's return for the year in which the taxpayer's transfer occurred.

Section 381(a) of the Code provides that, in the case of the acquisition of assets of a corporation by another corporation — (1) in a distribution to such corporation to which section 332 (relating to liquidations of subsidiaries) applies; or (2) in a transfer in which section 361 applies (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F) or (G) of section 368(a)(1), the acquiring corporation shall succeed to and take into account as of the close of the day of transfer, the items of the transferor corporation described in section 381(c) subject to certain conditions and limitations.

Section 332(a) of the Code generally provides that no gain or loss shall be recognized on receipt by a corporation of property distributed in complete liquidation of another corporation.

Section 368(a)(1)(A) of the Code provides, in part, that the term "reorganization" includes a statutory merger or consolidation.

Section 1.381(a)-1(b)(3)(i) of the regulations provides that section 381 does not apply to the carryover of an item or tax attribute not specified in section 381(c) of the Code. Section 381(c) does not refer to like kind exchanges under section 1031 of the Code. However, the legislative history of section 381 explains that "[T]he section is not intended to affect the carryover treatment of an item or tax attribute not specified in the section or the carryover treatment of items or tax attributes in corporate transactions not described in subsection (a). No inference is to be drawn from the enactment of this section whether any item or tax attribute may be utilized by a successor or predecessor corporation under existing law." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A135 (1954). See also section 1.381(a)-1(b)(3)(i) of the regulations (to the same effect). In other words, Congress did not intend the tax attributes listed in section 381(c) of the Code to be the exclusive list of attributes available for carryover. The legislative history further reveals that the purpose of section 381 is to put into practice the policy that "economic realities rather than ...such artificialities as the legal form of the reorganization" ought to control in the question of whether a tax attribute from an acquired corporation is to be carried over to the acquiring one. Section 381 was enacted "to enable the successor corporation to step into the "tax shoes" of its predecessor corporation without necessarily conforming to artificial legal requirements which [then existed at the time of its enactment] under court-made law." See S. Rep. No. 1622, 83rd Cong., 2d Sess. 52 (1954).

The special treatment of like-kind exchanges under section 1031 of the Code has been explained primarily on two grounds. First, a taxpayer making a like-kind exchange has received property similar to the property relinquished and therefore has not "cashed out" of the investment in the relinquished property. In addition, administrative problems may arise with respect to valuing property which is exchanged solely or primarily for similar property. See, e.g., Staff of the Joint Committee of Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 244-5 (1984); Starker v. United States, 602 F.2d 1341, 1352 (9th Cir. 1979).

The policy concerns which gave rise to section 1031 of the Code are no less applicable when the acquiring corporation, following liquidation under section 332 or a reorganization under section 368(a)(1), receives like-kind replacement property in exchange for relinquished property transferred by a liquidated or an acquired corporation prior to the liquidation or the reorganization. Accordingly, we conclude that for purposes of section 1031(a)(3) there is a carryover of tax attributes following both a section 332 liquidation and a section 368(a)(1)(A) reorganization. Thus, the intervening liquidations and reorganization, under the facts of this case, do not prevent the receipt of the replacement property by Taxpayer through nonelecting LLCs, as discussed above, from being treated as received in exchange for the relinquished property.

Section 301.7701-2(c)(2) of the regulations provides that, in general, a business entity that has a single owner and is not a corporation (as defined in section 301.7701-2(b)) is disregarded as an entity separate from its owner for federal tax purposes unless the entity elects to treat itself as an association for federal tax purposes. Because each wholly-owned, nonelecting LLC will be disregarded as an entity separate from its owner (i.e., Taxpayer) for federal tax purposes, the assets of the wholly-owned LLCs will be treated as assets of Taxpayer.

Based on the facts presented above, we rule that:

(1) Taxpayer will be treated as both the transferor of the relinquished properties and the transferee of the replacement property for purposes of section 1031(a) of the Code;

(2) The acquisition of the replacement property by each nonelecting LLC, wholly-owned by Taxpayer, will be deemed an acquisition by Taxpayer; and

(3) The transaction will not violate the requirement under section 1031(a)(1) that the like-kind replacement property "is to he [sic] held either for productive use in a trade or business or for investment" merely because the replacement property is received by one or more wholly-owned, nonelecting LLCs.

No opinion is expressed as to the application of any other provision of the Code or the regulations to the transaction at issue or as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction described which are not specifically covered in the above ruling. In particular, we express no opinion on whether the liquidations of S1 and S2 will qualify under section 332 of the Code or whether the merger of X with Taxpayer qualifies as a reorganization described under section 368(a)(1)(A).

A copy of this letter should be attached to the federal income tax return for the year in which the transaction in question occurs. This ruling is directed only to Taxpayer(s) who requested it. Section 6110(j)(3) of the Code provides that it may not be cited as precedent.

FRACTIONAL OWNERSHIP – TENANT-IN-COMMON AND DELAWARE STATUTORY TRUST

TENANT-IN-COMMON (TIC) OWNERSHIP PROGRAMS (ARTICLE)

THE CHALLENGE

Some investors hesitate to perform a §1031 exchange because the requirement to identify all replacement properties by the 45th day can be challenging to fulfill. In addition, it can be difficult to locate a second replacement property of exactly the right equity/value needed for a fully deferred exchange.

A SOLUTION - TIC PROPERTY

A potential solution is to acquire a fractional ownership interest in a tenant-in-common (TIC) property ownership interest in a large commercial property with multiple owners. A TIC interest represents co-ownership between two or more investors. In essence, rather than owning 100% of a smaller property, the investor receives a separate deed to an undivided interest, thus owning a fractional interest in a much larger property. A properly structured TIC is not a joint venture or a partnership. Instead, each co-owner has the same rights as would a single owner. Generally, a "management agreement" or "operating agreement" links the co-owners together. Most TIC properties provide creditworthy tenants and steady monthly income.

Some investors have chosen TIC property ownership because they can enjoy the benefits of appreciation, cash flow, annual depreciation and flexibility without management problems. In many cases, a TIC program provides the flexibility for an Exchanger to specify the exact amount of property that must be purchased to meet their specific exchange requirements. The column to the right highlights the advantages available to the average investor which in the past was previously reserved for large institutional investors.

BENEFITS OF TIC OWNERSHIP

- Geographic Diversification
- Economic Diversification
- Excellent Value
- Existing Financing
- Financial Diversification
- Flexibility
- Liquidity
- Low Minimum Investment
- Professional Management
- Predictable Performance

POTENTIAL RISKS

Great care should be taken so that the TIC arrangement is not considered a joint venture or partnership. A partnership interest is specifically excluded from tax deferral treatment under Section 1031. An investor considering any TIC program should have their tax/legal advisors thoroughly review the proposed ownership arrangement to assess whether or not the structure will likely meet the requirements of IRC Section 1031. In addition, the investment itself and property management should be evaluated.

TENANT-IN-COMMON UNDIVIDED FRACTIONAL INTERESTS (ARTICLE)

More real estate investors have been exploring the benefits of tenant-in-common ("TIC") programs that offer an undivided fractional interest in a large property with multiple owners. Investors have been interested in TIC programs because of the advantages of having partial ownership in a larger property which could offer appreciation, cash flow, annual depreciation benefits without many of the management problems typically associated with rental property.

BACKGROUND - REVENUE PROCEDURE 2000-46

In 2000, the government released Revenue Procedure 2000-46 which stated that the IRS would not issue any advance rulings or determination letters on whether or not a particular TIC program represented an undivided fractional interest in real property that would qualify for an IRC Section 1031 tax deferred exchange.

REVENUE PROCEDURE 2002-22

Revenue Procedure 2002-22 supersedes Revenue Procedure 2000-46 referenced above. Revenue Procedure 2002-22 addresses a couple of issues:

- Guidelines for requesting advance rulings to assist taxpayers in preparing a ruling request on a specific structure and proposed transaction.
- Conditions present in the proposed TIC structure under which the IRS normally will consider a request for a ruling.

These guidelines and conditions constitute requirements for advance rulings and are the clearest set of principles the IRS has set out as to its thinking on TIC programs.

REQUIRED GENERAL INFORMATION

The following information and copies of documents must be submitted with the ruling request:

- Name, taxpayer ID number, and percentage fractional interest;
- Name, taxpayer ID number, ownership of all persons involved in the acquisition, sale, lease (including the sponsor, lessee, manager and lender);
- Full description of the property;
- Representation that each co-owner holds title to the property as a tenant-in-common under local law;
- All promotional documents relating to the sale;
- All lending agreements;
- All agreements among the co-owners;
- Any lease agreements;
- Any purchase and sale agreements;
- Any property management or brokerage agreement;
- Any other agreement relating to the property including debt agreements and any call and put options relating to the property.

REVENUE PROCEDURE 2002-22

Internal Revenue Service (IRS)
Revenue Procedure (Rev. Proc.)
Released: March 19, 2002
Published: April 8, 2002

Undivided Fractional Interests in Real Estate

Section 267 — Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers, 26 CFR 1.267(a)-1: Deductions disallowed.

Section 511 — Imposition of Tax on Unrelated Business Income of Charitable, etc., Organizations, 26 CFR 1.511-1: Imposition and rates of tax.

Section 512 — Unrelated Business Taxable Income, 26 CFR 1.512(a)-1: Definition.

Section 707 — Transactions Between Partner and Partnership, 26 CFR 1.707-1: Transactions between partner and partnership.

Section 761 — Terms Defined, 26 CFR 1.761-1: Terms defined.

Section 856 — Definition of Real Estate Investment Trust, 26 CFR 1.856-1: Definition of real estate investment trust.

Section 1031 — Exchange of Property Held For Productive Use or Investment, 26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment.

Section 1361 — S Corporation Defined, 26 CFR 1.1361-1: S Corporation defined.

26 CFR 601.201: Rulings and determination letters.

This procedure specifies the conditions under which the Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity within the meaning of section 301.7701-3 of the regulations. Rev. Proc. 2000-46 superseded. Rev. Proc. 2002-3 modified.

SECTION 1. PURPOSE

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of Section 301.7701-2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000-46 (2000-2 C.B. 438), which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under Section 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under Â§ 7701. This revenue procedure also modifies Rev. Proc. 2002-3 (2002-1 I.R.B. 117) by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000-46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002- 1 (2002-1 I.R.B. 1) (or its successor).

SECTION 2. BACKGROUND

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Section 301.7701-3) that is not properly classified as a trust under Section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under Sections 301.7701-1, 301.7701-2, and 301.7701-3.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the

whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property Sections 50.01-50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75-374 (1975-2 C.B. 261) concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. See also Rev. Rul. 79-77 (1979-1 C.B. 448), which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in Bergford v. Commissioner, 12 F.3d 166 (9th Cir. 1993), seventy-eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford, 12 F.3d at 169-170. Accord Bussing v. Commissioner, 88 T.C. 449 (1987), aff'd on reh'g, 89 T.C. 1050 (1987); Alhouse v. Commissioner, T.C. Memo. 1991-652.

Under Section 1.761-1(a) and Sections 301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. Bergford, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Bussing, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. Bergford, 12 F.3d at 169.

SECTION 3. SCOPE

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

SECTION 4. GUIDELINES FOR SUBMITTING RULING REQUESTS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term "co-owner" means any person that owns an interest in the Property as a tenant in common. The term "sponsor" means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term "related person" means a person bearing a relationship described in Section 267(b) or

707(b)(1), except that in applying Section 267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term "disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of Section 856(i)(2)), qualified subchapter S subsidiaries (within the meaning of Section 1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term "blanket lien" means any mortgage or trust deed that is recorded against the Property as a whole.

SECTION 5. INFORMATION TO BE SUBMITTED

.01 Section 8 of Rev. Proc. 2002-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002-1; all material facts in the documents submitted must be explained in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in section 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02 Required General Information and Copies of Documents and Supplementary Materials. Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;

(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;

(3) A full description of the Property;

(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;

(5) All promotional documents relating to the sale of fractional interests in the Property;

(6) All lending agreements relating to the Property;

(7) All agreements among the co-owners relating to the Property;

(8) Any lease agreement relating to the Property;

(9) Any purchase and sale agreement relating to the Property;

(10) Any property management or brokerage agreement relating to the Property; and

(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

SECTION 6. CONDITIONS FOR OBTAINING RULINGS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

.01 Tenancy in Common Ownership. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in Section 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03 No Treatment of Co-Ownership as an Entity. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04 Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

.05 Voting. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

.06 Restrictions on Alienation. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

.07 Sharing Proceeds and Liabilities upon Sale of Property. If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

.08 Proportionate Sharing of Profits and Losses. Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09 Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.
.10 Options. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

.11 No Business Activities. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374 (1975-2 C.B. 261). Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in Section 511(a)(2) from qualifying as rent under Section 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

.12 Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

.13 Leasing Agreements. All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

.14 Loan Agreements. The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

.15 Payments to Sponsor. Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000-46 is superseded. Rev. Proc. 2002-3 is modified by removing sections 5.03 and 5.06.

SECTION 8. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622-3070 (not a toll-free call).

REVENUE PROCEDURE 2000-46

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 2000-3, 2000-1 LR.B. 103, which sets forth areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel in which the Internal Revenue Service will not issue advance rulings or determination letters.

SECTION 2. BACKGROUND

Section 5 of Rev. Proc. 2000-3 sets forth those areas under extensive

study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise.

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the entity is recognized as an entity under local law.

Section 301.7701-1(a)(2) provides that a joint undertaking or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. If such an entity is a business entity (i.e., is not a trust) with two or more members, the entity is classified for federal tax purposes either as a partnership or a corporation.

Section 1031(a)(1) provides 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. Sections 1031(a)(2)(B) and 1031(a)(2)(D) provide exceptions from the application of section 1031(a)(1) for stock and interests in a partnership, respectively.

The Service recently has become aware, in part through several requests for advance rulings, that taxpayers are taking the position that certain arrangements where taxpayers acquire undivided fractional interests in real property do not constitute separate entities for federal tax purposes and therefore the fractional interests may be the subject of tax-free exchanges under section 1031(a)(1). The Service intends to study further the facts and circumstances relevant to the determination of whether such arrangements are separate entities for federal tax purposes.

SECTION 3. PROCEDURE

Rev. Proc. 2000-3 is amplified by adding the following to section 5.10.

Section 1031. - Exceptions. - Whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under section 1031(a)(1).

Section 7701. - Definitions. - Whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes.

SECTION 4. EFFECTIVE DATE

This revenue procedure applies to all ruling requests, including any pending in the National Office and any submitted after the date of this publication.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000-3 is amplified.

SECTION 6. REQUEST FOR COMMENTS

The Service requests comments concerning this revenue procedure. In particular, comments are requested with respect to the relevance and impact of the following factors to the determination of whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes: (1) the terms of any leasing or management agreements entered into with respect to the property and the relationships between the parties to such agreements and the promoter or organizer of the arrangement; (2) the terms of any agreements between the promoter or organizer of the arrangement and the holders of the fractional interests or among the holders of the fractional interests, including any contractual restrictions to which the fractional interests are subject, such as waivers of the right to partition, rights of first refusal, and options to put and/or call the fractional interests; and (3) the overall economics of the arrangements, including the sharing of profits and losses from operating the property as well as of appreciation and depreciation in the value of the property. An original and eight copies of written comments should be sent to:

Internal Revenue Service Attn: CC:MSP:R (Rev. Proc. 2000-46) Room 5228 (PSI:Brl) P.O. Box 7604 Ben Franklin Station Washington, D.C. 20044 or hand delivered between the hours of 8 a.m. and 5 p.m. to:

Courier's Desk Internal Revenue Service Attn: CC!:MSP:R (Rev. Proc. 2000,-46) Room 5228 (PSI:Brl) 1111 Constitution Avenue, NW Washington, DC

Alternatively, taxpayers may submit comments electronically at: Joel.S.Rutstein@MI.IRSCounsel.treas.gov.

DRAFTING INFORMATION

The principal author of this revenue procedure is Jeanne Sullivan of the Office of the Associate Chief Counsel, Passthroughs & Special Industries. However, other personnel from the IRS and Treasury participated in its development. For further information, contact Jeanne Sullivan at (202) 622-3050 (not a toll-free number).

PRIVATE LETTER RULING 200625009

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: June 23, 2006
March 1, 2006

Section 7701 – Definitions

LEGEND:

Company =
LP =
A =
B =
C =
D =
Property =
X =
Date 1 =
a% =
b% =
c =

Dear ***:

This letter responds to a letter dated June 15, 2005, and subsequent correspondence, requesting on behalf of Company and LP a ruling that an undivided fractional interest in Property is not an interest in a business entity under Section 301.7701-2(a) of the Procedure and Administration Regulations for purposes of qualification of the undivided fractional interest as eligible replacement property under Section 1031(a) of the Internal Revenue Code. As requested, copies of this letter are being sent to your authorized representatives.

FACTS

According to the information submitted, Company and LP (co-owners) are unrelated business entities that have held title to Property as tenants in common and operated Property in accordance with a tenants-in-common agreement since Year 1. Company and LP entered into a contract with C, an affiliate of Company, to manage Property for a market-rate fee equal to a % of certain gross receipts from Property, and with D, another affiliate of Company, to negotiate and modify leases with tenants, subject to co-owners' approval. The agreement with C must be renewed annually by consent of both Company and LP. The agreement with D is terminable by either party at any time and market-rate lease commissions paid by tenants are fully passed through to a broker who works closely with D but is not an employee of or related to D. Moreover, Company and LP have made only customary repairs to Property, have not expanded or enlarged Property, and have not sold any portion of Property and reinvested the proceeds.

Property is leased to approximately c lessees, one of whom is X, an affiliate of LP. X leases approximately b% of Property and conducts a business that is unrelated to management and leasing of Property. All other lessees are unrelated to Company and LP. The rent payable under each lease is not dependent on the profits of any lessee. The lessees are required to repair, maintain, and insure their premises and pay all utilities and taxes related to premises. C collects rents, offsets expenses and distributes the proceeds pro rata to Company and LP, negotiates and modifies leases (subject to approval by Company and LP). Company and LP, through C, perform only customary services as defined in Revenue Ruling 75-374, 1975-2 C.B. 261, in operating Property.

The tenants-in-common agreement between Company and LP, and other agreements, provide that Company and LP each have a right to 50% of all income and an obligation to pay 50% of all expenses. Under the terms of the agreements, each of the co-owners retains the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of all or a portion of Property, the creation or modification of any blanket lien, the hiring of a property manager, resolving any claims, lawsuits, or demands of any type or nature whatsoever potentially affecting Property, and encumbering or pledging as collateral an interest in Property. If either co-owner advances funds necessary to pay expenses associated with the Property, the other co-owner must repay such advance within 31 days of the date the expense, obligation or liability was paid.

Each owner has the right to sell an interest in Property but, if the sale would result in a change in control of Property, a specified buy-sell procedure must be followed. A change in control is deemed to occur if any person or entity, other than A or descendants (as to Company) or B or descendants (as to LP) becomes the owner of securities or of membership interests in a co-owner representing 50% or more of the combined voting power of the co-owner's then outstanding ownership interests. The buy-sell procedure is as follows. The co-owner desiring to transfer or sell (the initiating co-owner) must give the other co-owner (the responding co-owner) a pre-offer notice that includes an initial due diligence disclosure (including but not limited to the most recent physical inspection report of the physical condition of the Property prepared by a professional building inspector not affiliated with the initiating co-owner, the most recently prepared environment report on the Property, a current rent roll, and a current profit and loss statement for its interest in the Property) and shall provide written notice of the initiating co-owner's intent to sell its interest in Property (a pre-offer notice). For a period of 30 days (the pre-offer period) the parties are to negotiate in good faith the terms of the sale or transfer and to obtain certain other inspections of the physical condition of the Property. If the co-owners do not reach agreement during the pre-offer period, the initiating co-owner may serve a formal offering notice on responding co-owner at a stated dollar amount. The purchase price shall be the stated dollar amount less that portion, corresponding to the seller's percentage interest in Property, of the principal balance and accrued interest outstanding on the closing

date of any loan secured by Property which is assumed by the purchaser. The responding co-owner has 90 days to elect to sell its interest or to purchase the offering co-owner's interest in Property for the purchase price in the offering notice. If the responding co-owner does not exercise either option within the option period, then the responding co-owner is conclusively deemed to have elected to sell his interest in the Property in accordance with the terms of the offering notice. Closing will occur 150 days after the date of the offering notice. Since Company and LP own a number of properties together, the first time a pre-offer notice is submitted, the 30 day period for negotiating is extended to 150 days. In addition, Company and LP have agreed to limit to 2 the number of properties that can be subject to a pre-offer notice within any 180 day period. Moreover, certain events are stipulated to extend the time periods by a specified period.

The co-owners retain the right to partition the Property but agree to invoke the buy-sell procedures (described above) prior to exercising the right. Moreover, the co-owners agree that the Property may be partitioned through arbitration. Property is subject to a loan extended by an unrelated lender that is guaranteed by certain affiliates of Company and LP, including X. If any co-owner or affiliate pays more than the co-owner's 50% share of the amount due under the loan agreement, pursuant to a guarantee or otherwise, that co-owner has a right to be indemnified by the other co-owner for the amount in excess of a 50% share of the expense.

LAW & ANALYSIS

Section 301.7701-1(a)(1) provides that whether an entity is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented and leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Section 301.7701- 3) that is not properly classified as a trust under Section 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.
Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.
Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under Sections 301.7701-1, 301.7701- 2, and 301.7701-3.
In Revenue Ruling 75-374, 1975-2 C.B. 261, the Service concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. In addition, in Revenue Ruling 79-77, 1979-1 C.B. 448, the Service concluded that the transfer of a commercial office building subject to a net lease to a trust having three individuals as beneficiaries was a trust for federal tax purposes and not a business entity.

In Revenue Procedure 2002-22, 2002-1 C.B. 733, the Service provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes. The conditions relate to tenancy in common ownership of the property, number of co-owners, no treatment of the co-ownership as an entity, co-ownership agreements, voting by co-owners, restrictions on alienation, sharing of proceeds and liabilities upon sale of the property, proportionate sharing of profits and losses, proportionate sharing of debt, options, no business activities by the co-owners, management and brokerage agreements, leasing agreements, loan agreements, and payments to sponsors. In addition, the revenue procedure sets forth a list of documents, supplementary materials, and general information required for a ruling.

Company and LP's co-ownership arrangement satisfies all of the conditions set forth in Revenue Procedure 2002-22. Specifically regarding voting, Section 6.05 of Revenue Procedure 2002-22 provides, in part, that the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. Relating to hiring a manager, Section 6.12 of Revenue Procedure 2002-22 provides, in part, that the co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee.

Company's Co-tenancy Agreement provides that any sale, lease, or re-lease of a portion or all the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, and the hiring of a manager, requires the approval of both co-owners. C is required to seek the approval of both co-owners for any matter outside day-to-day operational activities.

Specifically regarding business activities, Section 6.11 of Revenue Procedure 2002-22 provides that the co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Revenue Ruling 75-374. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in Â§511(a)(2) from qualifying as rent under Â§512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in

determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the property for less than 6 months. Under these facts, the co-owners' activities with respect to Property, conducted directly and through C and D, are limited to customary activities.

Section 6.04 of Revenue Procedure 2002-22 provides that the co-owners may agree that a co-owner must offer the co-ownership interest for sale to the other co-owner(s), the sponsor or lessee at fair market value (determined as of the time the partition right is exercised. Section 6.06 provides that, while each co-owner must have the right to transfer, partition, and encumber the co-owner's interest in the Property without the agreement or approval of any person, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. In this situation, in which there are only two 50% interests in Property, the restrictions on the co-owners' right to engage in activities that could diminish significantly the value of the other 50% interest in Property (such as pledging the interest in the Property as collateral or otherwise encumbering the interest) without the approval of the other co-owner is consistent with the requirement that each co-owner have the right to approve an arrangement that will create a lien on the Property. Moreover, the buy-sell procedure in this situation, in which the co-owners are unrelated and are dealing at arms' length, is consistent with establishing a right to acquire 50% of Property at fair market value.

CONCLUSION

Based on the facts submitted and representations made, we conclude that an undivided fractional interest in the Property will not constitute an interest in a business entity under Section 301.7701-2(a) for purposes of qualification of the undivided fractional interest as eligible replacement property under Section 1031(a).

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion concerning whether an undivided fractional interest in the Property otherwise qualifies as eligible replacement property under Section 1031(a) for federal tax purposes.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

Sincerely,

Jeanne M. Sullivan
Senior Technician Reviewer, Branch 3
(Passthroughs & Special Industries)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200521002

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: May 27, 2005
February 24, 2005

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

CC:ITA:B05
PLR-137528-04
TY:
LEGEND
Trust =
Decedent =
$X =
Year A =
X Beneficiaries =
Date A =
Date B =
Date C =
Date D =
Date E =
Date F =
Date G =
State A =
State B =
X percent =
Y percent =
Z percent =
LLC =
Relinquished Property =
$Y =
Buyer =
QI =

Dear ***:

This is in response to your request for a private letter ruling dated June 30, 2004, submitted by your authorized representatives as to the application of Section 1031(a) of the Internal Revenue Code to the proposed transaction. Specifically, you have requested a ruling that a testamentary trust may hold replacement property received in this like-kind exchange of real property "for productive use in a trade or business or for investment" within the meaning of Section 1031(a) notwithstanding that the trust must terminate by its own terms and thus distribute all of its properties, when the like-kind exchange is independent of the impending termination.

STATEMENT OF FACTS:

The following facts are pertinent to your ruling request. The Taxpayer is a private testamentary trust ("Trust") established by Decedent upon his death in Year A to administer his assets. Decedent's will provided for the establishment of the Trust in order to provide an ongoing source of safe and certain income to its beneficiaries, which included Decedent's wife and daughters. Under the terms of Decedent's will, the Trust will terminate at midnight on Date A, which is twenty years after the death of Decedent's last surviving child. Because the Trust is due to terminate, the trustees of the Trust ("Trustees") formulated a detailed Plan of Termination, which outlines a plan and mechanism for the distribution of the Trust's assets to its remainder beneficiaries upon its termination. Trust presently has X beneficiaries. Trust is required to distribute all of its income currently, may not make any other distributions to charitable or other beneficiaries, and is taxed as a "simple trust" under Section 651.

Originally, the assets of the Trust consisted mainly of real estate holdings in State A. The submission provides that, in order to diversify the Trust's real estate holdings, increase investment returns, and generate income, the Trustees received approval from the State A probate court many years ago to conduct exchanges of real estate. The Trustees have engaged in many such exchanges, which have been structured to qualify for nonrecognition treatment under Section 1031. Trust intends to continue to enhance its investment operations by strategically exchanging certain assets in its portfolio. As a result, the assets in the Trust now include real estate holdings in State A and diversified industrial, office, and retail properties located in other states. Your submission states that all of the Trust's directly-owned properties are held for investment purposes. Recently, the value of the Trust's assets approximated $X.

Under the Plan of Termination, approximately X percent of the Trust will be distributed on termination in cash to certain remainder beneficiaries. Y percent of the Trust will be distributed on termination through an in-kind distribution of one or more Trust properties to one expected remainder beneficiary. The remaining corpus (approximately Z percent) of the Trust's net asset value will be contributed by the Trustees prior to termination to

LLC, a to-be-formed State B limited liability company, with the Trust as the single member holding all of the shares in the LLC. All of the shares in LLC will then be distributed upon termination by the Trust among the remainder beneficiaries (to the extent their remainder interest is not otherwise satisfied with cash or in-kind property). LLC is intended to continue the Trust's real estate investment operations in a manner consistent with past practices. It is expected that much of the current managerial and operational structure will remain in place after the Trust terminates. The submission also provides that as a result of the large number of real estate parcels and the large number of beneficiaries, the Plan of Termination can only be effected by contributing the assets to an entity prior to and in conjunction with the Trust's terminating distributions. The Trustees submitted the Plan of Termination to the State A probate court, which approved it on Date B.

The Trustees have determined that it would be in the best interests of the Trust to dispose of the Relinquished Property in an exchange that would qualify for nonrecognition under Section 1031. The Relinquished Property includes the facilities and underlying land, together with all rights and appurtenances pertaining to the facilities and land.

The Trust entered into a disposition agreement dated Date C with Buyer to dispose of the Relinquished Property for $Y in cash. The Trust transferred Relinquished Property to Buyer on Date D. One day earlier, the Trust assigned its interest in the disposition agreement to QI, a qualified intermediary for purposes of the safe harbor provided in Section 1.1031(k)-1(g)(4) of the Income Tax Regulations, pursuant to an "Assignment and Assumption Agreement." The Trust also entered into "Exchange Agreement" with QI in order to facilitate the disposition of the Relinquished Property and the identification and acquisition of suitable replacement properties in accordance with the safe harbor deferred exchange regulations under Section 1031.

According to the submission, once identified and acquired in completion of the exchange, the Trustees intend to hold the replacement property solely to generate additional rental income and have no plans to develop or construct any improvements on the property, or to sell the replacement property or any portion of it at any time. Pursuant to the Plan of Termination, the Trustees will convey the replacement property to LLC sometime on or before Date F and will distribute all of the Trust's interests in LLC to certain beneficiaries on Date G (or as soon thereafter as possible). In addition, the Trust makes the following representations:

(1) The Relinquished Property now and at all times during the Trust's ownership thereof, has been held by the Trust for investment purposes;

(2) The disposition of the Relinquished Property and the acquisition of the replacement property will be accomplished in a manner that in all respects (aside from the future conveyance to LLC and the distribution of LLC to the beneficiaries of Trust upon termination) qualifies the transaction as a tax-free exchange within the meaning of Section 1031 and the regulations thereunder;

(3) The replacement property will be of "like kind" to the Relinquished Property for purposes of Section 1031 and will be held by the Trust (and then LLC) for investment purposes throughout the Trust's existence; and

(4) LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A at which time it will be deemed to become a partnership for federal income tax purposes as a result of the Trust's terminating distribution of the membership interests of LLC to multiple beneficiaries.

LAW AND ANALYSIS:

As stated above, you have requested a ruling that the Trust may hold replacement property received in this like-kind exchange of real property "for productive use in a trade or business or for investment" within the meaning of Section 1031(a) notwithstanding that the Trust must terminate by its own terms and distribute all of its properties, when the like-kind exchange is independent of the impending termination.

Section 1031(a)(1) provides 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 the property is exchanged solely for property of a like kind which is to be held either for productive use in a trade or business or for investment. Under Section 1.1031(a)-1(b) relating to the meaning of the term "like kind," real property is generally considered to be of like kind to all other real property, whether or not any of the real property involved is improved.

In Rev. Rul. 75-292,1975-2 C.B. 333, an individual taxpayer in a prearranged transaction transferred land and buildings used in the taxpayer's trade or business to an unrelated corporation in exchange for land and an office building owned by the corporation and used in its trade or business. Immediately thereafter, the individual taxpayer transferred the land and office building to the individual's newly created corporation in exchange for the stock of the same corporation in a transaction that qualified for nonrecognition of gain under Â§ 351. The revenue ruling concluded that the individual taxpayer did not exchange the real estate for other real estate to be held either for productive use in a trade or business or for investment by that taxpayer. Instead, the ruling concluded that the replacement property was acquired by the individual taxpayer for the purpose of transferring it to the new corporation in exchange for stock pursuant to Section 351. As a result, the ruling held that, as to that individual taxpayer, the exchange did not qualify for nonrecognition under Section 1031.

In Rev. Rul. 77-337, 1977-2 C.B. 305, an individual taxpayer owned all of the stock of a corporation. In a prearranged plan, the individual taxpayer liquidated the corporation and transferred the corporation's sole asset, a shopping center, to a third party in exchange for like-kind property. Rev. Rul. 77-337 noted that under Rev. Rul. 75-292, a newly created corporation's eventual productive use of property in its trade or business is not attributable to its sole shareholder. Rev. Rul. 77-337 thus concluded that the transaction between the individual taxpayer and the third party was a prearranged plan whereby the corporation was liquidated to facilitate the further exchange between the individual taxpayer and the third party of their respective properties. Consequently, the individual taxpayer did not hold the shopping center for use in a trade or business or for investment because the corporation's previous trade or business use could not be attributed to its sole shareholder. Therefore, the exchange did not qualify for nonrecognition of gain or loss under Section 1031.

Wagensen v. Commissioner, 74 T.C. 653 (1980), pertains in part to an exchange of real property, a ranch, for like-kind property followed by a gift of the newly acquired ranch property to the taxpayer's children. The court found that the exchange qualified under Section 1031. The ranch properties in question were held for use in a trade or business or for investment by taxpayer both before and after the exchange.

Under Section 301.7701-3(b)(1)(ii), a domestic eligible entity is generally (with exceptions noted) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-2(c)(2) provides that, in general, a business entity that has a single owner and is not a corporation (as defined in Section 301.7701-2(b)) is disregarded as an entity separate from its owner for federal tax purposes.

Your submission expresses two concerns regarding the above exchange. Your first concern is that the proposed transfer of the replacement property to LLC would violate the holding requirement of Section 1031(a) (i.e., that the replacement property must be held by the taxpayer for productive use in a trade or business or for investment) as applied in Rev. Rul. 75-292 and Rev. Rul. 77-337. Your second concern is that, as a result of the Trust's terminating distribution of membership interests in LLC to multiple beneficiaries, which will then result in a de facto partnership between the beneficiaries for federal income tax purposes, the holding requirement of Section 1031(a) as applied in the revenue rulings would be violated with respect to the replacement property.

With respect to your first concern, you represent that the replacement property will be held by the Trust (and LLC) for investment purposes throughout the Trust's existence. You also represent that LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A. Therefore, LLC will be disregarded as an entity separate from the Trust, its sole owner. Consequently, the transfer by the Trust of the replacement property to LLC will also be disregarded, and the Trust will be considered the direct owner of the replacement property for federal income tax purposes. Because the Trust represents that it intends to hold the replacement property for investment purposes, the transfer by the Trust of the replacement property to LLC will not violate the holding requirement of Section 1031(a).

With respect to your second concern, the Trust represents that it will hold the replacement property for investment purposes until the Trust terminates by its own terms on Date A. Because the Trust is a testamentary trust, the termination date was fixed by Decedent and cannot be modified or changed. As a result, the Trust is not acquiring the replacement property in order to dispose of the property pursuant to a prearranged plan. The Plan of Termination has been approved by the State A probate court and will take effect without regard to whether this exchange of properties is consummated. Consequently, the like-kind exchange in this case is wholly independent from the distribution of the properties under the Plan of Termination. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77-337.

CONCLUSION:

Therefore, based on the facts and representations presented above, we rule that the Trust's termination and distribution of its assets to the beneficiaries will not preclude the replacement property received by the Trust in this exchange from being considered property held either for productive use in a trade or business or investment, within the meaning of Section 1031, because this like-kind exchange is independent of the impending termination.

No determination is made by this ruling letter as to whether the described transaction otherwise qualifies for deferral of gain realized under Section 1031. We express no opinion, except as specifically ruled above, as to the federal income tax treatment of the transaction under any other provisions of the Code and regulations that may be applicable or under any other general principles of federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction(s) that are not specifically covered by the above ruling.

You should attach a copy of this ruling to your tax return for the taxable year in which the transaction covered by this ruling is consummated. We are enclosing a copy for that purpose.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. This ruling is directed only to the taxpayers who requested it.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.
Sincerely yours,

By:
Roy A. Hirschhorn
Assistant Branch Chief, Branch 5
Office of Associate Chief Counsel (Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200513010

Date:
December 06, 2004

Dear ********* :

This letter responds to a letter dated June 15, 2004, and subsequent correspondence, requesting a ruling on behalf of Company that an undivided fractional interest in rental real property is not an interest in a business entity under § 301.7701-2(a) of the Procedure and Administration Regulations for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a) of the Internal Revenue Code.

FACTS

According to the facts submitted and representations made, Company intends to acquire a fee interest in Property. Prior to the acquisition by Company, portions of Property will have been leased to *********. None of the tenants are related to Company. Under each lease, the tenant will be responsible for its pro-rata share of real estate taxes and operating expenses. In addition, each tenant will be responsible for the maintenance, repair and replacement of heating and air conditioning fixtures, equipment and systems, all lighting and plumbing fixtures, all interior walls, partitions, doors and windows, all exterior entrances, windows, doors and docks and the replacement of all broken glass. In addition, each tenant will keep and maintain Property and areas adjoining Property in a clean and orderly condition, free of accumulation of dirt, rubbish, snow and ice. The term of each lease will vary, but will generally be from ********* years. Company represents that the rent due under each lease will reflect the fair market value for the use of Property and will not depend, in whole or in part, on the income or profits derived by any person from Property. Company represents that all future leases entered into with respect to Property will be consistent with the leases in existence when Property is acquired.

Following acquisition, Company will create and sell undivided fractional interests in Property at fair market value to no more than 35 persons (Co-owners). Company will retain ********* a ********* % undivided fractional interest in Property. Each Co-owner will acquire its interest in Property by paying cash and/or assuming a pro-rata share of a blanket debt on, and all obligations relating to, Property.

Each Co-owner will be required to enter into a co-tenancy ownership agreement (co-tenancy agreement). The co-tenancy agreement will provide that the unanimous consent of all Co-owners shall be required to enter into any amendments, consents to assignment, subleases, re-leases, or modifications of any lease of Property or guarantees of lease, the sale of the Property, the appointment or reappointment of a property manager for Property under the management agreement, or the incurrence of any indebtedness secured by Property. For all other actions, the approval by holders of more than 50 percent of the undivided fractional interests will be required.

In addition, the co-tenancy agreement will provide for the allocation of income, expenses (including debt service payments for any debt which is a blanket lien on Property), and any net proceeds from a sale or refinancing of Property, among the Coowners in proportion to their respective ownership interests in Property.

Under the co-tenancy agreement, a Co-owner may, at any time, sell, finance, or otherwise create a lien upon the Co-owner's own interest, provided it does not create a lien on anyone else's interest. In addition, any Co-owner may freely sell, assign, or transfer all or a part of its interest in Property. Each Co-owner will also have the right, subject to any restrictions contained in any documents related to any loan on Property, to exercise a right of partition with respect to its interest in Property, and to file a complaint or institute any proceeding at law or in equity to have Property partitioned. However, before exercising any right to partition, each Co-Owner will agree to offer its interest for sale to the other Co-Owners at fair market value, as determined by an independent appraisal.

The co-tenancy agreement will further provide that each Co-owner will grant an option to the other Co-owners to acquire its interest at fair market value in the event: (i) there is a proposal to sell part or all of Property, or to incur indebtedness to be secured by Property, or to modify any lease (or guarantee of a lease) of Property and the Co-owner votes not to proceed in circumstances where holders of more than 50% of the Co-Ownership interests vote to proceed with the proposed action; or (ii) a Co-owner provides a notice of termination of the management agreement. If the proposed action is to sell part or all of Property to an unrelated third party who has made a bona fide offer, the fair market value shall be determined by reference to the price proposed for the entire property multiplied by the Co-owner's percentage interest in Property. Otherwise, the fair market value shall be determined by an independent appraisal of the total fair market value of the entire Property multiplied by the Co-owner's percentage interest in Property.

Following the purchase of an interest, each Co-owner will enter into a management agreement with Management Company. Management Company is related to Company through a common parent. Under the management agreement, Management Company will agree to manage all administrative, operational and management matters of Property, including but not limited to the management of all lease agreements. The management agreement will provide that each Co-owner who enters into the agreement retains the Management Company to act as the manager and oversee all administrative, operational and management matters of Property, which include monitoring the submission of rents and any other payments due under the lease, monitoring the payment of any taxes and special assessments with respect to Property, ensuring that they are paid in a timely fashion and commencing collection activities if a lessee is delinquent, requesting annual financial statements and other reports to the extent required from any lessee under the terms of the lease, overseeing the inspection of Property, monitoring lessee's compliance with terms of the lease, establishing accounts to hold funds collected pursuant to each lease and disbursing those funds to the Co-owners, providing customary property management services necessary to preserve, protect and enhance the value of Property, re-leasing Property, and providing for timely payment of principal, interest and other amounts due to any lender which has a blanket lien on Property. All activities with respect to Property will be customary services as defined in Rev. Rul. 75-374, 1975-2 C.B. 261.

Under the management agreement, Management Company will maintain full, accurate and complete records of the Co-owners' income and

operating expenses at its principal office and each Co-owner will have access to the records. Management Company will distribute to each Co-owner: (i) within 30 days after the end of each calendar quarter, financial statements prepared by the Management Company; (ii) within 90 days after the end of each calendar year, financial statements prepared by an independent accounting firm; and (iii) annual tax information relating to Property.

The management agreement will also provide that each Co-owner agrees to be obligated for a proportionate share of all costs associated with Property, to the extent that the revenues from Property are insufficient to cover the costs. In addition, if Property operates at a loss or if capital improvements, repairs or replacements are required, for which capital reserves do not exist, the Co-owners shall, upon request, make necessary payments in proportion to their individual ownership interests in Property. Distributions of each Co-owner's share of net revenue will be made at least quarterly.

The term of the management agreement will be 12 months (12-month term), renewable annually under the following procedures. At least ********* days, but no more than ********* days, prior to the end of each 12-month term (renewal period), the Management Company will provide Co-owners with a notice of renewal of the management agreement. Such notice will provide each Co-owner the opportunity to object to specific provisions of the agreement as well as to terminate the agreement as set forth in the notice of renewal. The notice of renewal will be sent to each Co-owner at the address provided by the Co-owner for this purpose using certified mail, return receipt requested (postage prepaid), or by using a nationally recognized courier service that guarantees overnight delivery, either alternative being an "approved notice method". The notice of renewal will set forth the following procedures and will include the names and addresses of each Co-owner.

Any Co-owner (objecting Co-owner) may cause the management agreement not to be renewed by providing a notice of termination to the Manager and to the other Cooowners by the approved notice method at least ********* days prior to the end of the renewal period, provided the objecting Co-owner sets forth a substitute manager and the material terms under which the substitute manager will be engaged. The engagement of the substitute manager shall be subject to the approval of each of the other Cooowners.

Each Co-owner shall have ********* days after the date of the notice of termination to provide written notice by the approved notice method to the Objecting Co-owner and the other Co-owners that the substitute manager is unacceptable and the reasons therefore.

If any Co-owner provides notice that the substitute manager is unacceptable, the following procedures apply.

1. The other non-objecting Co-owners may exercise the option to acquire the ownership interest(s) of the objecting Co-owner at fair market value.

2. If the other non-objecting Co-owners do not exercise their option to acquire the ownership interest of the objecting Co-owner, the objecting Co-owner, within --days of being notified that the alternative management arrangements are not acceptable, on its own behalf and at its own expense, may retain the substitute management company. As a result, the objecting Co-owner will cease to be a party to the original management agreement and will no longer be responsible to Management Company for any fees or associated expenses. However, the objecting Co-owner will remain subject to the terms of the co-tenancy agreement. In this event the objecting Co-owner must provide written notice to Management Company and the other non-objecting Co-owners. In such case, the managers must consult on all actions; however, except in cases in which unanimous approval of all Co-owners is required, the manager representing the controlling Co-owners shall be able to act without the approval of the co-manager.

3. The Co-owners who did not provide a notice of termination will be treated as consenting to a renewal of the Management Agreement.

In addition, a Co-owner may object to specific provisions in the Management Agreement by providing a notice of objection to the Management Company and to the other Co-owners within ********* days of the receipt of the notice of renewal. The Management Company and the Co-owner(s) may negotiate to modify specific terms of the Management Agreement. If no agreement is reached, a Co-owner may provide a notice of termination as described above on or before the ********* day before the end of the renewal period. Subsequently, the procedures described above will apply.

The management agreement will further provide that, notwithstanding the requirement that Management Company otherwise obtain unanimous consent for the lease or re-lease of all or any portion of Property, Management Company may, without obtaining consent of the Co-owners, lease (or re-lease) up to ********* % of the total leaseable space, in the aggregate. Any leases entered into by the Management Company pursuant to this provision must meet certain unanimously approved lease guidelines provided by the Co-owners annually. Such lease guidelines will include parameters relating to credit worthiness, type of tenants, rental ranges and length of rental term. Once unanimously agreed to, the lease guidelines cannot be altered or amended except upon the unanimous consent of all the Co-owners.

Under the management agreement, each Co-owner will be obligated to pay the Co-owner's pro rata share of a fee set at fair market value for the services provided. The fee will be payable irrespective of whether rents are actually collected. Management Company will be authorized to offset the costs of operating Property against any revenues derived from Property before distributing each Co-owner's proportionate share of net income. In addition, Management Company may advance funds on behalf of any Co-owner. The advance will be recourse as to each Co-owner and each Co-owner will be obligated to repay the advance within ********* days. In the event that the Co-owner is a disregarded entity that provides limited liability to the owner of the entity, the advance shall be recourse to the owner of the disregarded entity.

LAW & ANALYSIS

Section 301.7701-1(a)(1) provides that whether an entity is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that, for example, a separate entity exists for federal tax purposes if coowners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3.

In Rev. Rul. 75-374, 1975-2 C.B. 261, the Service concluded that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concluded that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the coownership gives rise to a partnership. For example, in Bergford v. Commissioner , 12 F.3d 166 (9 th Cir. 1993), seventy-eight investors purchased co-ownership interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford , 12 F.3d 169-170.

In Rev. Proc. 2002-22, 2002-1 C.B. 733, the Service provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes. The conditions relate to tenancy-in-common ownership of the property, number of coowners, no treatment of the co-ownership as an entity, co-ownership agreements, voting by co-owners, restrictions on alienation, sharing of proceeds and liabilities upon sale of the property, proportionate sharing of profits and losses, proportionate sharing of debt, options, no business activities by the co-owners, management and brokerage agreements, leasing agreements, loan agreements, and payments to sponsors. In addition, the revenue procedure sets forth a list of documents, supplementary materials, and general information required for a ruling.

Company's co-ownership arrangement satisfies all of the conditions set forth in Rev. Proc. 2002-22. Specifically regarding voting, § 6.05 of Rev. Proc. 2002-22 provides, in part, that the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or release of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. Relating to hiring a manager, § 6.12 of Rev. Proc. 2002-22 provides, in part, that the co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee.

Company's co-tenancy agreement provides that any sale, lease, or re-lease of a portion or all the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, and the hiring of a manager, requires the unanimous approval of the Coowners. All other actions on behalf of the co-ownership require the vote of those holding more than 50 percent of the undivided interests in the Property. The management agreement requires the Management Company to send a notice of renewal to each Co-owner annually at which time each Co-owner could exercise its right to terminate the management agreement. The renewal procedures allow each Coowner to exercise the right of an owner of real property to control the use of the Property. As a result, the provisions relating to changing managers and altering the management agreement satisfy the requirements of §§ 6.05 and 6.12 of Rev. Proc. 2002-22.

In addition, Company's management agreement provides that Management Company may lease or re-lease up to ********* % in the aggregate of the total leaseable space of Property based on specific lease guidelines unanimously approved by the Coowners. The lease guidelines will relate to the credit worthiness and type of tenant, rental ranges, and length of lease term. The guidelines can be amended only by unanimous agreement of the Co-owners. This arrangement to provide some limited flexibility in managing the leasing of Property while maintaining the owners' rights to direct and limit that flexibility satisfies the requirements of § 6.05 of Rev. Proc. 2002-22 .

Regarding business activities, § 6.11 of Rev. Proc. 2002-22 provides that the coowners' activities must be limited to those customarily performed in

connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the coowners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

Accordingly, the activities of Company and any person related to Company with respect to the Property must be taken into account in determining whether the Coowners' activities are customary activities under § 6.11 of Rev. Proc. 2002-22. After acquiring and leasing the Property, Company will create and sell undivided fractional interests in the Property at fair market value. Company will continue to own ********* a ********* % undivided interest in Property and is related to Management Company through a common parent. The Property will be leased under a net lease to unrelated tenants. In addition, Company represents that the only activities of the Co-owners, including Company, (or any person related to the Co-owners) with respect to the Property will be customary activities within the meaning of § 6.11 of Rev. Proc. 2002-22.

CONCLUSION

Based on the facts submitted and representations made, we conclude that an undivided fractional interest in Property will not constitute an interest in a business entity under § 301.7701-2(a) for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a).

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion concerning whether an undivided fractional interest in the Property otherwise qualifies as eligible replacement property under § 1031(a) for federal tax purposes.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely Yours,

Jeanne Sullivan
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

PRIVATE LETTER RULING 200327003

Date: March 7, 2003

Legend:

Company =
Management Company =

Dear [redacted text]:

This letter responds to a letter dated November 21, 2002, and subsequent correspondence, requesting on behalf of Company a ruling that an undivided fractional interest in rental real property is not an interest in a business entity under § 301.7701-2(a) of the Procedure and Administration Regulations for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a) of the Internal Revenue Code.

FACTS

According to the information submitted, Company intends to acquire a fee interest in commercial real property ("Property") with its own cash. There will be no liens on the Property. Company will lease the Property to a single corporate tenant ("Lessee"). Rent under the lease will be at fair market value and will not depend on the income or profits derived by any person from the leased Property. The lease will be a "triple net lease" under which the Lessee is responsible for all costs and expenses related to the Property, including real estate taxes, maintenance, insurance and repairs ("Lease").

After acquiring and leasing the property, Company will create and sell undivided fractional interests in the Property at fair market value to no more than 35 persons, including itself if it retains an interest ("Co-owners"), some or all of whom intend to acquire such interests as replacement property under § 1031. Company will continue to hold an interest in the Property until all fractional interests are sold, which may take up to 18 months or longer to complete. Neither Company nor any person related to Company will finance any portion of the purchase price of a purchaser's fractional interest. Each Co-owner will hold legal title to the Property as a tenant in common under local law.

The Co-owners will not hold themselves out as partners to third parties, conduct business under a common name, or file a partnership income tax return. Company represents that the only activities of the Co-owners (or any person related to the Co- owners) with respect to the Property will be activities that would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder.

Each Co-owner will enter into a co-tenancy ownership agreement ("Co-tenancy Agreement"), which will govern the relationship among the Co-owners. The Co-tenancy Agreement will provide that any sale of the entire Property, any lease or re-lease of a portion or all of the Property, any negotiation or renegotiation of any indebtedness secured by any blanket lien, and the appointment of any manager must be approved by unanimous vote of the Co-owners. For all other actions, only the approval by holders of more than 50 percent on the undivided fractional interests is required. Income and expenses are allocated among the Co-owners in proportion to their individual ownership interests in the Property. A Co-owner may, at any time, sell, finance, or otherwise create a lien upon the Co-owner's own interest, subject to terms of the Co-tenancy Agreement, provided it does not create a lien on anyone else's interest. Any Co-owner is free to sell, assign, or transfer all or a part of its interest in the Property, subject to the terms of the Co-tenancy Agreement. Finally, there is no waiver of partition rights among the Co-owners.

Each Co-owner may, but will not be required to, enter into a management agreement ("Management Agreement") with Management Company ("Manager"), to provide accounting, insurance monitoring, and lease monitoring activities for the Co- owners. Management Company is an entity that is part of a controlled group of corporations, within the meaning of § 1563(a), with Company. The Management Agreement provides that each Co-owner who enters into the agreement retains the Manager to act as the manager and oversee all administrative, operational and management matters of the Property, which include the management of the Lease, the obtaining of various consents when required, monitoring and enforcing the terms of the Lease, re-leasing the Property, maintenance of the Property, receiving and monitoring the rental revenue and paying certain expenses, distributing the rental proceeds after the payment of expenses, sending notices of default and otherwise overseeing collection efforts as required, monitoring the payment of taxes by the lessee, and inspecting the underlying premises.

The Management Agreement also provides that each Co-owner agrees to be obligated for a proportionate share of all cost's associated with the Property. Distributions of each Co-owner's share of net revenue will be made quarterly. Any Co- owner may terminate the Management Agreement provisions concerning accounting and distributions at any time and seek to collect its share directly from the tenant. If the Property operates at a loss or if capital improvements, repairs or replacements are required, the Co-owners shall, upon request, make necessary payments in proportion to their individual ownership interests in the Property.

In addition, the Management Agreement provides that not less than annually, the Manager will provide each Co-owner with an annual written notice of the renewal of the agreement. The notice shall provide each Co-owner with the opportunity to exercise the Co-owner's right to terminate the agreement, which can be done at any time under the agreement with just 60 days notice. Otherwise, the Management Agreement will continue in force until the sale of the entire fee interest in the premises by each Co- owner. Any advance made by the Manager on behalf of any Co-owner are on a recourse basis and must be repaid within a 30-day period following the advance. Each Co-owner is obligated to pay a fee set a fair market value for the services provided. The fee is payable irrespective of whether rents are actually collected. The Manager is authorized to offset the costs of operating the Property against any revenues derived from the Property before distributing each Co-owner's proportionate share of net income. Finally, the books and records relating to the Property will be maintained at the principal office of the Manager.

LAW & ANALYSIS

Section 301.7701-1(a)(1) provides that whether an entity is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co- ownership of property that is maintained, kept in repair, and rented and leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3.

In Rev. Rul. 75-374, 1975-2 C.B. 261, the Service concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling c oncludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. In addition, in Rev. Rul. 79-77, 1979-1 C.B. 448, the Service concluded that the transfer of a commercial office building subject to a net lease to a trust having three individuals as beneficiaries was a trust for federal tax purposes and not a business entity.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in Bergford v. Commissioner, 12 F.3d 166 (9th Cir. 1993), seventy-eight investors purchased "co- ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co- owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement ot the manager performed any remarketing. A co-owner could assign an interest in the co- ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford, 12 F.3d 169-170.

In Rev. Proc. 2002-22, 2002-14 I.R.B. 733, the Service provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes. The conditions relate to tenancy in common ownership of the property, number of co-owners, no treatment of the co-ownership as an entity, co-ownership agreements, voting by co-owners, restrictions on alienation, sharing of proceeds and liabilities upon sale of the property, proportionate sharing of profits and losses, proportionate sharing of debt, options, no business activities by the co-owners, management and brokerage agreements, leasing agreements, loan agreements, and payments to sponsors. In addition, the revenue procedure sets forth a list of documents, supplementary materials, and general information required for a ruling.

Company's co-ownership arrangement satisfies all of the conditions set forth in Rev. Proc. 2002-22. Specifically regarding voting, § 6.05 of Rev. Proc. 2002-22 provides, in part, that the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property, or the creation or modification of a blanket lien. Any sale, lease, or re- lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. Relating to hiring a manager, § 6.12 of Rev. Proc. 2002-22 provides, in part, that the co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee.

Company's Co-tenancy Agreement provides that any sale, lease, or re-lease of a portion or all the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, and the hiring of a manager, requires the unanimous approval of the Co- owners. All other actions on behalf of the co-ownership require the vote of those holding more than 50 percent of the undivided interests in the property. Company's Management Agreement, which the Co-owners may enter into, requires the manager to send a notice of renewal to each Co-owner annually at which time each Co-owner could exercise its right to terminate the management agreement at any time with just 60 days notice. Although not an affirmative consent, the notice requirement in Company's management agreement containing the right of any Co-owner to terminate the agreement at any time with just 60 days notice satisfies the conditions in §§ 6.05 and 6.12 of Rev. Proc. 2002-22 regarding unanimous annual renewals of any management agreement.

Specifically regarding business activities, § 6.11 of Rev. Proc. 2002-22 provides that the co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co- owner owns an undivided interest in the property for less than 6 months.

Accordingly, the activities of Company and any person related to Company with respect to the property must be taken into account in determining whether the co- owners' activities are customary activities under § 6.11 of Rev. Proc. 2002-22. After acquiring and leasing the property, Company will create and sell undivided fractional interests in the Property at fair market value. Company will continue to own some undivided interests in the property until all are sold, which may take 18 months or longer to complete. During this period, the property will be leased to a lessee under a triple net lease, thereby limiting the activities by the Co-owners. In addition, Company represents that the only activities of the Co-owners, including Company, (or any person related to the Co-owners) with respect to the property will be activities that would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. Therefore, Company's activities in the capacity as a Co-owner during this period after acquiring and leasing the Property will not violate the condition regarding no business activity under § 6.11 of Rev. Proc. 2002-22.

CONCLUSION

Based on the facts submitted and representations made, we conclude that an undivided fractional interest in the Property will not constitute an interest in a business entity under § 301.7701-2(a) for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a).

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion concerning whether an undivided fractional interest in the Property otherwise qualifies as eligible replacement property under § 1031(a) for federal tax purposes.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely Yours,

JEANNE SULLIVAN
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

PRIVATE LETTER RULING 200019019

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: May 12, 2000
February 10, 2000

Section 1031 — Exchange of Property Held for Productive Use or Investment
Section 752 — Treatment of Certain Liabilities
Section 761 — Terms Defined

LEGEND:

CC:DOM:IT&A:5-PLR-109811-99
Taxpayer:
Taxpayer's EIN:
Taxpayer's Address:
Legend
A =
B =
C =
D =
E =
F =
Taxpayers =
State M =
R =
S =
T =
Corporation =
x =
y =
z =
Year 1 =
Year 2 =

Dear *** :

This letter is in response to the request for a private letter ruling dated May 24, 1999, regarding issues under Sections 1031, 761, and 752 of the Internal Revenue Code. The facts regarding the transaction in question are as follows:

Taxpayers in this ruling request are six State M limited partnerships: A, B, C, D, E, and F. The partnerships all have the same general and limited partners. The limited partners, R, S, and T, each own an x interest in A, C, D, E, and F, and a y interest in B. The general partner in the partnerships is Corporation, a State M business corporation. Corporation owns a y interest in A, C, D, E, and F, and a z interest in B.

The properties owned by the partnerships are mobile home parks, which are real properties improved with the following items:

A: 173 concrete pads for mobile home sites;

B: 171 pads for mobile home sites, a single family dwelling which is rented to third parties, a barn, and four additional concrete block structures, three of which are leased for the operation of businesses serving the park and the general public, and one is a laundry facility which serves the park residents;

C: 131 pads for mobile home sites;

D: 140 pads for mobile home sites;

E: 103 pads for mobile home sites, and a well and sewage treatment plant, which provide water and sewerage disposal for the mobile home sites, and a storage rental facility;

F: 78 mobile home pads and a single family dwelling which is rented to third parties.

Taxpayers also represent that personal property associated with the mobile home parks will be traded in the exchange transactions.

Taxpayers plan to enter into an exchange agreement with a "Qualified Intermediary," in which the above-listed relinquished properties will be transferred to the Qualified Intermediary, who will sell the relinquished properties and hold the proceeds ("exchange funds"). Taxpayers' rights to the

proceeds will be limited to the circumstances specified in Section 1.1031(k)- 1(g)(6) of the Income Tax Regulations. Taxpayers will then select replacement properties, which the Qualified Intermediary will purchase within the required statutory period, and then transfer to the Taxpayers.

Taxpayers have indicated that the as-yet unidentified replacement properties will likely consist of apartment complexes, and each partnership will own an undivided interest in the replacement properties as tenants in common with the other partnerships. To the extent that the replacement properties require some management in order to generate a rental income stream, Corporation will manage the properties, furnishing only those services which are customary in connection with the rental, maintenance and repair of the properties.

The relinquished properties are all subject to mortgages for amounts borrowed by the partnerships. In July, Year 1, Taxpayers refinanced the mortgages to take advantage of lower interest rates, and some of the proceeds of the refinancing were distributed to the partners, who purchased more properties. It is represented that Taxpayers did not contemplate the exchanges at the time of the refinancing; Taxpayers were first approached concerning the exchange transactions in February, Year 2. It is further represented that the aggregate amount of mortgages on the replacement properties (the "Debt Amount") will be greater than or equal to the refinanced mortgages on the relinquished properties.

It is anticipated that the lenders making the mortgages for the purchase of the replacement properties will require that all of the partnerships be jointly and severally liable for those mortgages. The partnerships will enter into a debt-sharing agreement which will (i) allocate the risk of loss among the partnerships so as to ensure that the amount of each partnership's debt is not reduced by the exchange, (ii) obligate each of the partnerships to make sure its proportional share of payments on the loans is secured by the replacement properties, and (iii) obligate each of the partnerships to indemnify the other partnerships against any failure to make such payments.

Rulings Requested

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the mobile home parks currently owned by the partnerships for undivided interests in other income-producing property as tenants in common will be an exchange of property of a like kind or class.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.

4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a) of the Code, the partnerships will recognize no gain or loss, except to the extent that the exchange funds together with the Debt Amount, exceed the purchase price of the replacement properties; and except to the extent that the value of any personal property included with the relinquished property exceeds the value of all personal property included with the replacement property.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

Law and Analysis

Rulings 1, 2, 3, and 4

Section 1.1031(a)-1(a) of the regulations provides, in part, that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) provides, in part, that as used in Section 1031(a) of the Code, the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Section 1.1031(a)-1(c) provides that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Section 1.1031(a)-2(b) provides that depreciable tangible personal property is exchanged for property of a "like kind" under Section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like kind or class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class.

Section 1.1031(j)-1(a) provides, in part, that as a general rule, the application of Section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like -kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than

one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group.

Section 1.1031(k)-1(a) provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

Section 1.1031(k)-1(f)(1) provides in part that in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property.

Section 1.1031(k)-1(g)(4)(i) provides that when a deferred exchange involves a qualified intermediary, the qualified intermediary is not considered an agent of the taxpayer for purposes of Section 1031(a) of the Code. Thus, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Section 1.1031(k)-1(g)(4)(ii) states that paragraph (g)(4)(i) applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the rights of the taxpayer to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

Section 1.1031(k)-1(g)(4)(iii) provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

In Garcia v. Commissioner, 80 T.C. 491 (1983), the owners of the replacement property were required to obtain another mortgage on the property, which had the effect of "evening up" the liabilities on both sides of the exchange. The court found that the taxpayers' assumption of this liability as part of the exchange transaction had independent economic significance aside from tax avoidance and, therefore, no boot was recognized by the taxpayers.

The taxpayer in Fredericks v. Commissioner, T.C. Memo. 1994-27, refinanced his mortgage after the exchange agreement was entered into, but before the properties were actually exchanged. Although the taxpayer received cash from the refinancing, the court held that the receipt of such cash was not considered boot because the taxpayer had reasons for refinancing that were unrelated to the exchange, namely, to obtain a lower interest rate and the fact that the original loan was due shortly.

Taxpayers represent that the relinquished properties are held for investment purposes, and are being exchanged for tenancy-in-common interests in apartment complexes, which will also be held for investment purposes. Rev. Rul. 73- 476, 1973-2 C.B. 300, holds that the exchange of tenancy-in-common interests in real property for a fee simple interest in real property is an exchange of property of a like kind under Section 1031(a). Accordingly, we conclude that the relinquished real properties are of a like kind to the proposed replacement properties for purposes of Section 1031. To the extent that the partnerships transfer personal property as part of the relinquished property, there will be an exchange of multiple properties under Section 1.1031(j)-1. The partnerships should calculate the gain or loss attributable to the exchange of the personal property in accordance with the provisions of those regulations.

In the present case, Taxpayers propose to enter into a deferred exchange. Taxpayers represent that the exchange transactions will be accomplished through the use of a qualified intermediary as defined in Section 1.1031(k)-1(g)(4). Taxpayers represent that after entering into the purchase agreement with the buyer of the relinquished properties, they will transfer their rights under the purchase agreement to the qualified intermediary, thereby giving the qualified intermediary the legal title and power to transfer the relinquished properties. Once the qualified intermediary sells the relinquished property and receives the proceeds, those proceeds will be held by the qualified intermediary, and Taxpayers' rights to receive, pledge, borrow, or otherwise obtain the benefits of the proceeds will be limited to those situations specified in Section 1.1031(k)-1(g)(6). Accordingly, the transaction will qualify as a deferred exchange rather than a sale of the properties.

The refinancing issue in the present case is similar to Fredericks, supra, because the refinancing in Year 1 had an economic significance that is independent from the proposed exchange. Taxpayers received lower interest rates on their loans, and the proceeds from the refinancing were used by the partners to purchase more properties. Accordingly, the proceeds of the Year 1 refinancing will not be considered as payments of boot in the exchange transaction.

Rulings 5 and 6

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate.

Section 1.761-1 provides, in part, that the term "partnership" is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. See Section 7701(a)(2). The regulation also provides that mere coownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Tenants in common may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. The furnishing of customary services in connection with the maintenance and repair of the apartments will not render a coownership a partnership. However, the furnishing of additional services will render a coownership a partnership if the additional services are furnished directly by the coowners or through their agent.

In Rev. Rul. 75-374, 1975-2 C.B. 261, two parties each owned an undivided one-half interest in an apartment project. A management company retained by the co-owners managed the building. Customary tenant services such as heat and water, unattended parking, trash removal, normal

repairs, and cleaning of public areas were furnished at no additional charge. Additional services, such as attendant parking, cabanas, and gas and electricity were provided by the management company for a separate charge. The ruling holds that the furnishing of customary services in connection with the maintenance and repair of an apartment project will not render a co-ownership a partnership. The furnishing of additional services by the owners or through an agent will render a co-ownership a partnership. The revenue ruling concludes that since the management company is not an agent of the owners and the owners did not share the income earned from the additional services, the owners were not furnishing services. Therefore, the owners are to be treated as co-owners and not partners under Section 761.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of the liabilities, is considered a contribution of money by that partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered a distribution of money to that partner by the partnership.

Taxpayers represent that to the extent the replacement properties need to be managed, they will be managed by Corporation. In managing any of the properties, Corporation will only provide those services which are usual and customary to maintain the replacement properties, such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, cleaning of public areas, and trash removal, and will not render additional services. Based upon such representations, we conclude that the partnerships' ownership and operation of the replacement properties as tenants in common will not be treated as a partnership or as an association taxable as a corporation for federal income tax purposes.

With respect to the repayment of the Debt Amount, Taxpayers represent that the indebtedness outstanding with respect to each partnership before the Section 1031 exchange is considered recourse indebtedness (within the meaning of Section 1.752-2) with respect to the partnership. The partnerships will enter into a debt agreement whereby each partnership will be liable for its proportionate share of payments on the mortgage and will be indemnified by the other partnerships to the extent that it pays more than its proportionate share.

Further, Taxpayers represent that each partnership's portion of the debt will obligate the partnership in an amount at least equal to the amount of liabilities for which the partnership was liable before the exchange and acquisition of the replacement properties. Accordingly, we also conclude that the joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.
Conclusions

Based upon Taxpayers' representations and the above analysis, we rule as follows:

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the fee simple interests in the real and personal property comprising the mobile home parks to be relinquished by the partnerships for undivided interests in other real and personal property represented to be of a like kind or class to be held as tenants in common will qualify as a like-kind exchange under Section 1031.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.

4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a), the partnerships will recognize no gain or loss, except to the extent that the sum of the proceeds from the relinquished properties and the Debt Amount exceeds the purchase price of the replacement properties, and except as provided in Section 1.1031(j)-1.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel (Income Tax and Accounting)
Douglas A. Fahey
Assistant to the Chief, Branch 5
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200019018

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: May 12, 2000
February 10, 2000

Section 1031 — Exchange of Property Held for Productive Use or Investment
Section 752 — Treatment of Certain Liabilities
Section 761 — Terms Defined

LEGEND:

CC:DOM:IT&A:5-PLR-109812-99
Taxpayer:
Taxpayer's EIN:
Taxpayer's Address:
Legend
A =
B =
C =
D =
E =
F =
Taxpayers =
State M =
R =
S =
T =
Corporation =
x =
y =
z =
Year 1 =
Year 2 =

Dear ***:

This letter is in response to the request for a private letter ruling dated May 24, 1999, regarding issues under Sections 1031, 761, and 752 of the Internal Revenue Code. The facts regarding the transaction in question are as follows:

Taxpayers in this ruling request are six State M limited partnerships: A, B, C, D, E, and F. The partnerships all have the same general and limited partners. The limited partners, R, S, and T, each own an x interest in A, C, D, E, and F, and a y interest in B. The general partner in the partnerships is Corporation, a State M business corporation. Corporation owns a y interest in A, C, D, E, and F, and a z interest in B.

The properties owned by the partnerships are mobile home parks, which are real properties improved with the following items:

A: 173 concrete pads for mobile home sites;

B: 171 pads for mobile home sites, a single family dwelling which is rented to third parties, a barn, and four additional concrete block structures, three of which are leased for the operation of businesses serving the park and the general public, and one is a laundry facility which serves the park residents;

C: 131 pads for mobile home sites;

D: 140 pads for mobile home sites;

E: 103 pads for mobile home sites, and a well and sewage treatment plant, which provide water and sewerage disposal for the mobile home sites, and a storage rental facility;

F: 78 mobile home pads and a single family dwelling which is rented to third parties.
Taxpayers also represent that personal property associated with the mobile home parks will be traded in the exchange transactions.

Taxpayers plan to enter into an exchange agreement with a "Qualified Intermediary," in which the above-listed relinquished properties will be transferred to the Qualified Intermediary, who will sell the relinquished properties and hold the proceeds ("exchange funds"). Taxpayers' rights to the proceeds will be limited to the circumstances specified in Â§ 1.1031(k)- 1(g)(6) of the Income Tax Regulations. Taxpayers will then select replacement properties, which the Qualified Intermediary will purchase within the required statutory period, and then transfer to the Taxpayers.

Taxpayers have indicated that the as-yet unidentified replacement properties will likely consist of apartment complexes, and each partnership will own an undivided interest in the replacement properties as tenants in common with the other partnerships. To the extent that the replacement properties require some management in order to generate a rental income stream, Corporation will manage the properties, furnishing only those services which are customary in connection with the rental, maintenance and repair of the properties.

The relinquished properties are all subject to mortgages for amounts borrowed by the partnerships. In July, Year 1, Taxpayers refinanced the mortgages to take advantage of lower interest rates, and some of the proceeds of the refinancing were distributed to the partners, who purchased more properties. It is represented that Taxpayers did not contemplate the exchanges at the time of the refinancing; Taxpayers were first approached concerning the exchange transactions in February, Year 2. It is further represented that the aggregate amount of mortgages on the replacement properties (the "Debt Amount") will be greater than or equal to the refinanced mortgages on the relinquished properties.

It is anticipated that the lenders making the mortgages for the purchase of the replacement properties will require that all of the partnerships be jointly and severally liable for those mortgages. The partnerships will enter into a debt-sharing agreement which will (i) allocate the risk of loss among the partnerships so as to ensure that the amount of each partnership's debt is not reduced by the exchange, (ii) obligate each of the partnerships to make sure its proportional share of payments on the loans is secured by the replacement properties, and (iii) obligate each of the partnerships to indemnify the other partnerships against any failure to make such payments.

Rulings Requested

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the mobile home parks currently owned by the partnerships for undivided interests in other income-producing property as tenants in common will be an exchange of property of a like kind or class.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.
4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a) of the Code, the partnerships will recognize no gain or loss, except to the extent that the exchange funds together with the Debt Amount, exceed the purchase price of the replacement properties; and except to the extent that the value of any personal property included with the relinquished property exceeds the value of all personal property included with the replacement property.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

Law and Analysis

Rulings 1, 2, 3, and 4

Section 1.1031(a)-1(a) of the regulations provides, in part, that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) provides, in part, that as used in Section 1031(a) of the Code, the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Section 1.1031(a)-1(c) provides that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Section 1.1031(a)-2(b) provides that depreciable tangible personal property is exchanged for property of a "like kind" under Section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like kind or class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class.

Section 1.1031(j)-1(a) provides, in part, that as a general rule, the application of Section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like -kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group.

Section 1.1031(k)-1(a) provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

Section 1.1031(k)-1(f)(1) provides in part that in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property.

Section 1.1031(k)-1(g)(4)(i) provides that when a deferred exchange involves a qualified intermediary, the qualified intermediary is not considered an agent of the taxpayer for purposes of Section 1031(a) of the Code. Thus, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Section 1.1031(k)-1(g)(4)(ii) states that paragraph (g)(4)(i) applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the rights of the taxpayer to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

Section 1.1031(k)-1(g)(4)(iii) provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

In Garcia v. Commissioner, 80 T.C. 491 (1983), the owners of the replacement property were required to obtain another mortgage on the property, which had the effect of "evening up" the liabilities on both sides of the exchange. The court found that the taxpayers' assumption of this liability as part of the exchange transaction had independent economic significance aside from tax avoidance and, therefore, no boot was recognized by the taxpayers.

The taxpayer in Fredericks v. Commissioner, T.C. Memo. 1994-27, refinanced his mortgage after the exchange agreement was entered into, but before the properties were actually exchanged. Although the taxpayer received cash from the refinancing, the court held that the receipt of such cash was not considered boot because the taxpayer had reasons for refinancing that were unrelated to the exchange, namely, to obtain a lower interest rate and the fact that the original loan was due shortly.

Taxpayers represent that the relinquished properties are held for investment purposes, and are being exchanged for tenancy-in-common interests in apartment complexes, which will also be held for investment purposes. Rev. Rul. 73- 476, 1973-2 C.B. 300, holds that the exchange of tenancy-in-common interests in real property for a fee simple interest in real property is an exchange of property of a like kind under Section 1031(a). Accordingly, we conclude that the relinquished real properties are of a like kind to the proposed replacement properties for purposes of Section 1031.

To the extent that the partnerships transfer personal property as part of the relinquished property, there will be an exchange of multiple properties under Section 1.1031(j)-1. The partnerships should calculate the gain or loss attributable to the exchange of the personal property in accordance with the provisions of those regulations.

In the present case, Taxpayers propose to enter into a deferred exchange. Taxpayers represent that the exchange transactions will be accomplished through the use of a qualified intermediary as defined in Section 1.1031(k)-1(g)(4). Taxpayers represent that after entering into the purchase agreement with the buyer of the relinquished properties, they will transfer their rights under the purchase agreement to the qualified intermediary, thereby giving the qualified intermediary the legal title and power to transfer the relinquished properties. Once the qualified intermediary sells the relinquished property and receives the proceeds, those proceeds will be held by the qualified intermediary, and Taxpayers' rights to receive, pledge, borrow, or otherwise obtain the benefits of the proceeds will be limited to those situations specified in Section 1.1031(k)-1(g)(6). Accordingly, the transaction will qualify as a deferred exchange rather than a sale of the properties.

The refinancing issue in the present case is similar to Fredericks, supra, because the refinancing in Year 1 had an economic significance that is independent from the proposed exchange. Taxpayers received lower interest rates on their loans, and the proceeds from the refinancing were used by the partners to purchase more properties. Accordingly, the proceeds of the Year 1 refinancing will not be considered as payments of boot in the exchange transaction.

Rulings 5 and 6

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate.

Section 1.761-1 provides, in part, that the term "partnership" is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. See Section 7701(a)(2). The regulation also provides that mere coownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Tenants in common may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. The furnishing of customary services in connection with the maintenance and repair of the apartments will not render a coownership a partnership. However, the furnishing of additional services will render a coownership a partnership if the additional services are furnished directly by the coowners or through their agent.

In Rev. Rul. 75-374, 1975-2 C.B. 261, two parties each owned an undivided one-half interest in an apartment project. A management company retained by the co-owners managed the building. Customary tenant services such as heat and water, unattended parking, trash removal, normal repairs, and cleaning of public areas were furnished at no additional charge. Additional services, such as attendant parking, cabanas, and gas and electricity were provided by the management company for a separate charge. The ruling holds that the furnishing of customary services in connection

with the maintenance and repair of an apartment project will not render a co-ownership a partnership. The furnishing of additional services by the owners or through an agent will render a co-ownership a partnership. The revenue ruling concludes that since the management company is not an agent of the owners and the owners did not share the income earned from the additional services, the owners were not furnishing services. Therefore, the owners are to be treated as co-owners and not partners under Section 761.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of the liabilities, is considered a contribution of money by that partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered a distribution of money to that partner by the partnership.

Taxpayers represent that to the extent the replacement properties need to be managed, they will be managed by Corporation. In managing any of the properties, Corporation will only provide those services which are usual and customary to maintain the replacement properties, such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, cleaning of public areas, and trash removal, and will not render additional services. Based upon such representations, we conclude that the partnerships' ownership and operation of the replacement properties as tenants in common will not be treated as a partnership or as an association taxable as a corporation for federal income tax purposes.

With respect to the repayment of the Debt Amount, Taxpayers represent that the indebtedness outstanding with respect to each partnership before the Section 1031 exchange is considered recourse indebtedness (within the meaning of Section 1.752-2) with respect to the partnership. The partnerships will enter into a debt agreement whereby each partnership will be liable for its proportionate share of payments on the mortgage and will be indemnified by the other partnerships to the extent that it pays more than its proportionate share.

Further, Taxpayers represent that each partnership's portion of the debt will obligate the partnership in an amount at least equal to the amount of liabilities for which the partnership was liable before the exchange and acquisition of the replacement properties. Accordingly, we also conclude that the joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

Conclusions

Based upon Taxpayers' representations and the above analysis, we rule as follows:

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the fee simple interests in the real and personal property comprising the mobile home parks to be relinquished by the partnerships for undivided interests in other real and personal property represented to be of a like kind or class to be held as tenants in common will qualify as a like-kind exchange under Section 1031.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.

4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a), the partnerships will recognize no gain or loss, except to the extent that the sum of the proceeds from the relinquished properties and the Debt Amount exceeds the purchase price of the replacement properties, and except as provided in Â§ 1.1031(j)-1.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel (Income Tax and Accounting)
Douglas A. Fahey
Assistant to the Chief, Branch 5
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200019017

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: May 12, 2000
February 10, 2000

Section 1031 — Exchange of Property Held for Productive Use or Investment
Section 752 — Treatment of Certain Liabilities
Section 761 — Terms Defined

LEGEND:

CC:DOM:IT&A:5-PLR-109813-99
Taxpayer:
Taxpayer's EIN:
Taxpayer's Address:
Legend
A =
B =
C =
D =
E =
F =
Taxpayers =
State M =
R =
S =
T =
Corporation =
x =
y =
z =
Year 1 =
Year 2 =

Dear ***:

This letter is in response to the request for a private letter ruling dated May 24, 1999, regarding issues under Sections 1031, 761, and 752 of the Internal Revenue Code. The facts regarding the transaction in question are as follows:

Taxpayers in this ruling request are six State M limited partnerships: A, B, C, D, E, and F. The partnerships all have the same general and limited partners. The limited partners, R, S, and T, each own an x interest in A, C, D, E, and F, and a y interest in B. The general partner in the partnerships is Corporation, a State M business corporation. Corporation owns a y interest in A, C, D, E, and F, and a z interest in B.

The properties owned by the partnerships are mobile home parks, which are real properties improved with the following items:

A: 173 concrete pads for mobile home sites;

B: 171 pads for mobile home sites, a single family dwelling which is rented to third parties, a barn, and four additional concrete block structures, three of which are leased for the operation of businesses serving the park and the general public, and one is a laundry facility which serves the park residents;

C: 131 pads for mobile home sites;

D: 140 pads for mobile home sites;

E: 103 pads for mobile home sites, and a well and sewage treatment plant, which provide water and sewerage disposal for the mobile home sites, and a storage rental facility;

F: 78 mobile home pads and a single family dwelling which is rented to third parties.

Taxpayers also represent that personal property associated with the mobile home parks will be traded in the exchange transactions.

Taxpayers plan to enter into an exchange agreement with a "Qualified Intermediary," in which the above-listed relinquished properties will be transferred to the Qualified Intermediary, who will sell the relinquished properties and hold the proceeds ("exchange funds"). Taxpayers' rights to the

proceeds will be limited to the circumstances specified in Section 1.1031(k)- 1(g)(6) of the Income Tax Regulations. Taxpayers will then select replacement properties, which the Qualified Intermediary will purchase within the required statutory period, and then transfer to the Taxpayers.

Taxpayers have indicated that the as-yet unidentified replacement properties will likely consist of apartment complexes, and each partnership will own an undivided interest in the replacement properties as tenants in common with the other partnerships. To the extent that the replacement properties require some management in order to generate a rental income stream, Corporation will manage the properties, furnishing only those services which are customary in connection with the rental, maintenance and repair of the properties.

The relinquished properties are all subject to mortgages for amounts borrowed by the partnerships. In July, Year 1, Taxpayers refinanced the mortgages to take advantage of lower interest rates, and some of the proceeds of the refinancing were distributed to the partners, who purchased more properties. It is represented that Taxpayers did not contemplate the exchanges at the time of the refinancing; Taxpayers were first approached concerning the exchange transactions in February, Year 2. It is further represented that the aggregate amount of mortgages on the replacement properties (the "Debt Amount") will be greater than or equal to the refinanced mortgages on the relinquished properties.

It is anticipated that the lenders making the mortgages for the purchase of the replacement properties will require that all of the partnerships be jointly and severally liable for those mortgages. The partnerships will enter into a debt-sharing agreement which will (i) allocate the risk of loss among the partnerships so as to ensure that the amount of each partnership's debt is not reduced by the exchange, (ii) obligate each of the partnerships to make sure its proportional share of payments on the loans is secured by the replacement properties, and (iii) obligate each of the partnerships to indemnify the other partnerships against any failure to make such payments.

Rulings Requested

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the mobile home parks currently owned by the partnerships for undivided interests in other income-producing property as tenants in common will be an exchange of property of a like kind or class.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.

4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a) of the Code, the partnerships will recognize no gain or loss, except to the extent that the exchange funds together with the Debt Amount, exceed the purchase price of the replacement properties; and except to the extent that the value of any personal property included with the relinquished property exceeds the value of all personal property included with the replacement property.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

Law and Analysis

Rulings 1, 2, 3, and 4

Section 1.1031(a)-1(a) of the regulations provides, in part, that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) provides, in part, that as used in Section 1031(a) of the Code, the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Section 1.1031(a)-1(c) provides that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Section 1.1031(a)-2(b) provides that depreciable tangible personal property is exchanged for property of a "like kind" under Section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like kind or class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class.

Section 1.1031(j)-1(a) provides, in part, that as a general rule, the application of Section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like -kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than

one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group.

Section 1.1031(k)-1(a) provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

Section 1.1031(k)-1(f)(1) provides in part that in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property.

Section 1.1031(k)-1(g)(4)(i) provides that when a deferred exchange involves a qualified intermediary, the qualified intermediary is not considered an agent of the taxpayer for purposes of Section 1031(a) of the Code. Thus, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Section 1.1031(k)-1(g)(4)(ii) states that paragraph (g)(4)(i) applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the rights of the taxpayer to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

Section 1.1031(k)-1(g)(4)(iii) provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

In Garcia v. Commissioner, 80 T.C. 491 (1983), the owners of the replacement property were required to obtain another mortgage on the property, which had the effect of "evening up" the liabilities on both sides of the exchange. The court found that the taxpayers' assumption of this liability as part of the exchange transaction had independent economic significance aside from tax avoidance and, therefore, no boot was recognized by the taxpayers.

The taxpayer in Fredericks v. Commissioner, T.C. Memo. 1994-27, refinanced his mortgage after the exchange agreement was entered into, but before the properties were actually exchanged. Although the taxpayer received cash from the refinancing, the court held that the receipt of such cash was not considered boot because the taxpayer had reasons for refinancing that were unrelated to the exchange, namely, to obtain a lower interest rate and the fact that the original loan was due shortly.

Taxpayers represent that the relinquished properties are held for investment purposes, and are being exchanged for tenancy-in-common interests in apartment complexes, which will also be held for investment purposes. Rev. Rul. 73- 476, 1973-2 C.B. 300, holds that the exchange of tenancy-in-common interests in real property for a fee simple interest in real property is an exchange of property of a like kind under Section 1031(a). Accordingly, we conclude that the relinquished real properties are of a like kind to the proposed replacement properties for purposes of Section 1031.

To the extent that the partnerships transfer personal property as part of the relinquished property, there will be an exchange of multiple properties under Â§ 1.1031(j)-1. The partnerships should calculate the gain or loss attributable to the exchange of the personal property in accordance with the provisions of those regulations.

In the present case, Taxpayers propose to enter into a deferred exchange. Taxpayers represent that the exchange transactions will be accomplished through the use of a qualified intermediary as defined in Section 1.1031(k)-1(g)(4). Taxpayers represent that after entering into the purchase agreement with the buyer of the relinquished properties, they will transfer their rights under the purchase agreement to the qualified intermediary, thereby giving the qualified intermediary the legal title and power to transfer the relinquished properties. Once the qualified intermediary sells the relinquished property and receives the proceeds, those proceeds will be held by the qualified intermediary, and Taxpayers' rights to receive, pledge, borrow, or otherwise obtain the benefits of the proceeds will be limited to those situations specified in Section 1.1031(k)-1(g)(6). Accordingly, the transaction will qualify as a deferred exchange rather than a sale of the properties.

The refinancing issue in the present case is similar to Fredericks, supra, because the refinancing in Year 1 had an economic significance that is independent from the proposed exchange. Taxpayers received lower interest rates on their loans, and the proceeds from the refinancing were used by the partners to purchase more properties. Accordingly, the proceeds of the Year 1 refinancing will not be considered as payments of boot in the exchange transaction.

Rulings 5 and 6

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate.

Section 1.761-1 provides, in part, that the term "partnership" is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. See Â§ 7701(a)(2). The regulation also provides that mere coownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Tenants in common may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. The furnishing of customary services in connection with the maintenance and repair of the apartments will not render a coownership a partnership. However, the furnishing of additional services will render a coownership a partnership if the additional services are furnished directly by the coowners or through their agent.

In Rev. Rul. 75-374, 1975-2 C.B. 261, two parties each owned an undivided one-half interest in an apartment project. A management company retained by the co-owners managed the building. Customary tenant services such as heat and water, unattended parking, trash removal, normal repairs, and cleaning of public areas were furnished at no additional charge. Additional services, such as attendant parking, cabanas, and gas and electricity were provided by the management company for a separate charge. The ruling holds that the furnishing of customary services in connection with the maintenance and repair of an apartment project will not render a co-ownership a partnership. The furnishing of additional services by the owners or through an agent will render a co-ownership a partnership. The revenue ruling concludes that since the management company is not an agent of the owners and the owners did not share the income earned from the additional services, the owners were not furnishing services. Therefore, the owners are to be treated as co-owners and not partners under Section 761.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of the liabilities, is considered a contribution of money by that partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered a distribution of money to that partner by the partnership.

Taxpayers represent that to the extent the replacement properties need to be managed, they will be managed by Corporation. In managing any of the properties, Corporation will only provide those services which are usual and customary to maintain the replacement properties, such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, cleaning of public areas, and trash removal, and will not render additional services. Based upon such representations, we conclude that the partnerships' ownership and operation of the replacement properties as tenants in common will not be treated as a partnership or as an association taxable as a corporation for federal income tax purposes.

With respect to the repayment of the Debt Amount, Taxpayers represent that the indebtedness outstanding with respect to each partnership before the Section 1031 exchange is considered recourse indebtedness (within the meaning of Section 1.752-2) with respect to the partnership. The partnerships will enter into a debt agreement whereby each partnership will be liable for its proportionate share of payments on the mortgage and will be indemnified by the other partnerships to the extent that it pays more than its proportionate share.

Further, Taxpayers represent that each partnership's portion of the debt will obligate the partnership in an amount at least equal to the amount of liabilities for which the partnership was liable before the exchange and acquisition of the replacement properties. Accordingly, we also conclude that the joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.
Conclusions

Based upon Taxpayers' representations and the above analysis, we rule as follows:

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the fee simple interests in the real and personal property comprising the mobile home parks to be relinquished by the partnerships for undivided interests in other real and personal property represented to be of a like kind or class to be held as tenants in common will qualify as a like-kind exchange under Section 1031.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.
4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a), the partnerships will recognize no gain or loss, except to the extent that the sum of the proceeds from the relinquished properties and the Debt Amount exceeds the purchase price of the replacement properties, and except as provided in Section 1.1031(j)-1.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel (Income Tax and Accounting)
Douglas A. Fahey
Assistant to the Chief, Branch 5
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200019016

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: May 12, 2000
February 10, 2000

Section 1031 — Exchange of Property Held for Productive Use or Investment
Section 752 — Treatment of Certain Liabilities
Section 761 — Terms Defined

LEGEND:

CC:DOM:IT&A:5-PLR-109814-99
Taxpayer:
Taxpayer's EIN:
Taxpayer's Address:
Legend
A =
B =
C =
D =
E =
F =
Taxpayers =
State M =
R =
S =
T =
Corporation =
x =
y =
z =
Year 1 =
Year 2 =

Dear ***:

This letter is in response to the request for a private letter ruling dated May 24, 1999, regarding issues under Sections 1031, 761, and 752 of the Internal Revenue Code. The facts regarding the transaction in question are as follows:

Taxpayers in this ruling request are six State M limited partnerships: A, B, C, D, E, and F. The partnerships all have the same general and limited partners. The limited partners, R, S, and T, each own an x interest in A, C, D, E, and F, and a y interest in B. The general partner in the partnerships is Corporation, a State M business corporation. Corporation owns a y interest in A, C, D, E, and F, and a z interest in B.

The properties owned by the partnerships are mobile home parks, which are real properties improved with the following items:

A: 173 concrete pads for mobile home sites;

B: 171 pads for mobile home sites, a single family dwelling which is rented to third parties, a barn, and four additional concrete block structures, three of which are leased for the operation of businesses serving the park and the general public, and one is a laundry facility which serves the park residents;

C: 131 pads for mobile home sites;

D: 140 pads for mobile home sites;

E: 103 pads for mobile home sites, and a well and sewage treatment plant, which provide water and sewerage disposal for the mobile home sites, and a storage rental facility;

F: 78 mobile home pads and a single family dwelling which is rented to third parties.

Taxpayers also represent that personal property associated with the mobile home parks will be traded in the exchange transactions.

Taxpayers plan to enter into an exchange agreement with a "Qualified Intermediary," in which the above-listed relinquished properties will be transferred to the Qualified Intermediary, who will sell the relinquished properties and hold the proceeds ("exchange funds"). Taxpayers' rights to the

proceeds will be limited to the circumstances specified in Section 1.1031(k)- 1(g)(6) of the Income Tax Regulations. Taxpayers will then select replacement properties, which the Qualified Intermediary will purchase within the required statutory period, and then transfer to the Taxpayers.

Taxpayers have indicated that the as-yet unidentified replacement properties will likely consist of apartment complexes, and each partnership will own an undivided interest in the replacement properties as tenants in common with the other partnerships. To the extent that the replacement properties require some management in order to generate a rental income stream, Corporation will manage the properties, furnishing only those services which are customary in connection with the rental, maintenance and repair of the properties.

The relinquished properties are all subject to mortgages for amounts borrowed by the partnerships. In July, Year 1, Taxpayers refinanced the mortgages to take advantage of lower interest rates, and some of the proceeds of the refinancing were distributed to the partners, who purchased more properties. It is represented that Taxpayers did not contemplate the exchanges at the time of the refinancing; Taxpayers were first approached concerning the exchange transactions in February, Year 2. It is further represented that the aggregate amount of mortgages on the replacement properties (the "Debt Amount") will be greater than or equal to the refinanced mortgages on the relinquished properties.

It is anticipated that the lenders making the mortgages for the purchase of the replacement properties will require that all of the partnerships be jointly and severally liable for those mortgages. The partnerships will enter into a debt-sharing agreement which will (i) allocate the risk of loss among the partnerships so as to ensure that the amount of each partnership's debt is not reduced by the exchange, (ii) obligate each of the partnerships to make sure its proportional share of payments on the loans is secured by the replacement properties, and (iii) obligate each of the partnerships to indemnify the other partnerships against any failure to make such payments.

Rulings Requested

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the mobile home parks currently owned by the partnerships for undivided interests in other income-producing property as tenants in common will be an exchange of property of a like kind or class.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.

4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a) of the Code, the partnerships will recognize no gain or loss, except to the extent that the exchange funds together with the Debt Amount, exceed the purchase price of the replacement properties; and except to the extent that the value of any personal property included with the relinquished property exceeds the value of all personal property included with the replacement property.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

Law and Analysis

Rulings 1, 2, 3, and 4

Section 1.1031(a)-1(a) of the regulations provides, in part, that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) provides, in part, that as used in Section 1031(a) of the Code, the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Section 1.1031(a)-1(c) provides that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Section 1.1031(a)-2(b) provides that depreciable tangible personal property is exchanged for property of a "like kind" under Section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like kind or class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class.

Section 1.1031(j)-1(a) provides, in part, that as a general rule, the application of Section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like -kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than

one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group.

Section 1.1031(k)-1(a) provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

Section 1.1031(k)-1(f)(1) provides in part that in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property.

Section 1.1031(k)-1(g)(4)(i) provides that when a deferred exchange involves a qualified intermediary, the qualified intermediary is not considered an agent of the taxpayer for purposes of Section 1031(a) of the Code. Thus, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Section 1.1031(k)-1(g)(4)(ii) states that paragraph (g)(4)(i) applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the rights of the taxpayer to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

Section 1.1031(k)-1(g)(4)(iii) provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

In Garcia v. Commissioner, 80 T.C. 491 (1983), the owners of the replacement property were required to obtain another mortgage on the property, which had the effect of "evening up" the liabilities on both sides of the exchange. The court found that the taxpayers' assumption of this liability as part of the exchange transaction had independent economic significance aside from tax avoidance and, therefore, no boot was recognized by the taxpayers.

The taxpayer in Fredericks v. Commissioner, T.C. Memo. 1994-27, refinanced his mortgage after the exchange agreement was entered into, but before the properties were actually exchanged. Although the taxpayer received cash from the refinancing, the court held that the receipt of such cash was not considered boot because the taxpayer had reasons for refinancing that were unrelated to the exchange, namely, to obtain a lower interest rate and the fact that the original loan was due shortly.

Taxpayers represent that the relinquished properties are held for investment purposes, and are being exchanged for tenancy-in-common interests in apartment complexes, which will also be held for investment purposes. Rev. Rul. 73- 476, 1973-2 C.B. 300, holds that the exchange of tenancy-in-common interests in real property for a fee simple interest in real property is an exchange of property of a like kind under Sectino 1031(a). Accordingly, we conclude that the relinquished real properties are of a like kind to the proposed replacement properties for purposes of Section 1031. To the extent that the partnerships transfer personal property as part of the relinquished property, there will be an exchange of multiple properties under Section 1.1031(j)-1. The partnerships should calculate the gain or loss attributable to the exchange of the personal property in accordance with the provisions of those regulations.

In the present case, Taxpayers propose to enter into a deferred exchange. Taxpayers represent that the exchange transactions will be accomplished through the use of a qualified intermediary as defined in Section 1.1031(k)-1(g)(4). Taxpayers represent that after entering into the purchase agreement with the buyer of the relinquished properties, they will transfer their rights under the purchase agreement to the qualified intermediary, thereby giving the qualified intermediary the legal title and power to transfer the relinquished properties. Once the qualified intermediary sells the relinquished property and receives the proceeds, those proceeds will be held by the qualified intermediary, and Taxpayers' rights to receive, pledge, borrow, or otherwise obtain the benefits of the proceeds will be limited to those situations specified in Section 1.1031(k)-1(g)(6). Accordingly, the transaction will qualify as a deferred exchange rather than a sale of the properties.

The refinancing issue in the present case is similar to Fredericks, supra, because the refinancing in Year 1 had an economic significance that is independent from the proposed exchange. Taxpayers received lower interest rates on their loans, and the proceeds from the refinancing were used by the partners to purchase more properties. Accordingly, the proceeds of the Year 1 refinancing will not be considered as payments of boot in the exchange transaction.

Rulings 5 and 6

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate.

Section 1.761-1 provides, in part, that the term "partnership" is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. See Section 7701(a)(2). The regulation also provides that mere coownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Tenants in common may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. The furnishing of customary services in connection with the maintenance and repair of the apartments will not render a coownership a partnership. However, the furnishing of additional services will render a coownership a partnership if the additional services are furnished directly by the coowners or through their agent.

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repairs, and cleaning of public areas were furnished at no additional charge. Additional services, such as attendant parking, cabanas, and gas and electricity were provided by the management company for a separate charge. The ruling holds that the furnishing of customary services in connection with the maintenance and repair of an apartment project will not render a co-ownership a partnership. The furnishing of additional services by the owners or through an agent will render a co-ownership a partnership. The revenue ruling concludes that since the management company is not an agent of the owners and the owners did not share the income earned from the additional services, the owners were not furnishing services. Therefore, the owners are to be treated as co-owners and not partners under Section 761.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of the liabilities, is considered a contribution of money by that partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered a distribution of money to that partner by the partnership.

Taxpayers represent that to the extent the replacement properties need to be managed, they will be managed by Corporation. In managing any of the properties, Corporation will only provide those services which are usual and customary to maintain the replacement properties, such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, cleaning of public areas, and trash removal, and will not render additional services. Based upon such representations, we conclude that the partnerships' ownership and operation of the replacement properties as tenants in common will not be treated as a partnership or as an association taxable as a corporation for federal income tax purposes.

With respect to the repayment of the Debt Amount, Taxpayers represent that the indebtedness outstanding with respect to each partnership before the Section 1031 exchange is considered recourse indebtedness (within the meaning of Section 1.752-2) with respect to the partnership. The partnerships will enter into a debt agreement whereby each partnership will be liable for its proportionate share of payments on the mortgage and will be indemnified by the other partnerships to the extent that it pays more than its proportionate share.

Further, Taxpayers represent that each partnership's portion of the debt will obligate the partnership in an amount at least equal to the amount of liabilities for which the partnership was liable before the exchange and acquisition of the replacement properties. Accordingly, we also conclude that the joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

Conclusions

Based upon Taxpayers' representations and the above analysis, we rule as follows:

1. The exchange of the relinquished properties for the replacement properties through the use of a qualified intermediary will not result in the constructive receipt of the exchange funds by the partnerships.

2. The exchange of the fee simple interests in the real and personal property comprising the mobile home parks to be relinquished by the partnerships for undivided interests in other real and personal property represented to be of a like kind or class to be held as tenants in common will qualify as a like-kind exchange under Section 1031.

3. The proceeds of the refinancing of the partnerships' debts in Year 1 will not be considered as payments of boot in the exchange transactions.

4. The exchange of the relinquished properties for the replacement properties will be an exchange of property for which, under Section 1031(a), the partnerships will recognize no gain or loss, except to the extent that the sum of the proceeds from the relinquished properties and the Debt Amount exceeds the purchase price of the replacement properties, and except as provided in Section 1.1031(j)-1.

5. The ownership of the replacement properties by the partnerships as tenants in common after the completion of the exchanges will not result in the formation of a partnership among the partnerships with respect to the ownership and operation of the replacement properties.

6. The joint and several obligation of the partnerships to repay the Debt Amount will not result in a reduction in any partner's share of partnership debt.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel (Income Tax and Accounting)
Douglas A. Fahey
Assistant to the Chief, Branch 5
This document may not be used or cited as precedent.

DELAWARE STATUTORY TRUSTS (ARTICLE)

Creative Ways to Sell and Defer Taxation

Installment Sales, Structured Sales and Deferred Sales Trust

Internal Revenue Code (IRC) Section 1031 tax deferred exchanges provide many benefits to real estate sellers. Taxpayers selling real estate may want to explore with their tax and/or legal advisors the advantages and disadvantages of other methods of selling appreciated property.

Installment Sale

IRC §453 (the installment sale rules) allows a seller who sells appreciated property on an installment basis to defer paying capital gain taxes to future tax years when installment payments are actually received. This strategy is often referred to as seller financing. The advantage of seller financing is deferring recognition of taxable gain to later years. The disadvantage of this method is the risk the buyer will default in making the payments and the seller will need to foreclose on the property.

Structured Sale

A structured sale is similar to seller financing except the buyer is not making the payments to the seller of the relinquished property. The seller assigns the buyer's note to a financial institution (usually a large insurance company). The seller receives payments in the form of a Single Premium Immediate Annuity (SPIA). The SPIA obligates the financial institution to pay the seller over the seller's lifetime. The main advantage to the seller is that the payment obligation is transferred from the buyer to the financial institution thereby eliminating the risk of the buyer's default. Disadvantages include market risks (payments do not increase relative to inflation) and, in most cases, the annuity payments cease upon the seller's death leaving nothing for the beneficiaries.

Deferred Sales Trust

A Deferred Sales Trust (DST) is similar to a structured sale, except that an irrevocable trust is formed and substituted for the financial institution. One advantage of a DST is that it generates a stream of payments that spread the tax liability over time. Disadvantages of a DST include the need to use an independent trustee to manage the trust and the assets remaining in the DST are subject to estate taxes at death in some cases. A DST can invest its funds into a variety of prudent investments including stocks, bonds, mutual funds, annuities and real estate.

Steps Involving Creating a DST

1. Establish the DST before the asset or property is sold.
2. Transfer ownership of the asset to the DST.
3. The DST provides a document to the seller that explains the terms of the underlying installment sale and specifies the payments of principal and income.
4. The assets or property are sold by the DST to a third-party buyer.

REVENUE RULING 2004-86

Internal Revenue Service (I.R.S.)
Revenue Ruling (Rev. Rul.)
Released: July 20, 2004
Published: August 16, 2004

CLASSIFICATION OF DELAWARE STATUTORY TRUST

Section 671 — Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners

How will certain Delaware statutory trusts be classified for federal tax purposes and may a taxpayer acquire an interest in certain Delaware statutory trusts without recognition of gain or loss under section 1031 of the Internal Revenue Code.

Section 677 — Income for Benefit of Grantor

How will certain Delaware statutory trusts be classified for federal tax purposes and may a taxpayer acquire an interest in certain Delaware statutory trusts without recognition of gain or loss under section 1031 of the Internal Revenue Code.

Section 761 — Terms Defined

How will certain Delaware statutory trusts be classified for federal tax purposes and may a taxpayer acquire an interest in certain Delaware statutory trusts without recognition of gain or loss under section 1031 of the Internal Revenue Code.

Section 1031 — Exchange of Property Held for Productive Use or Investment

How will certain Delaware statutory trusts be classified for federal tax purposes and may a taxpayer acquire an interest in certain Delaware statutory trusts without recognition of gain or loss under section 1031 of the Internal Revenue Code.

26 CFR 301.7701-1: Classification of organizations for federal tax purposes.

Classification of Delaware statutory trust. This ruling explains how a Delaware statutory trust described in the ruling will be classified for federal tax purposes and whether a taxpayer may acquire an interest in the Delaware statutory trust without recognition of gain or loss under section 1031 of the Code. Rev. Ruls. 78-371 and 92-105 distinguished.

Classification of Delaware statutory trust. This ruling explains how a Delaware statutory trust described in the ruling will be classified for federal tax purposes and whether a taxpayer may acquire an interest in the Delaware statutory trust without recognition of gain or loss under section 1031 of the Code. Rev. Ruls. 78-371 and 92-105 distinguished.

ISSUE(S)

(1) In the situation described below, how is a Delaware statutory trust, described in Del. Code Ann. title 12, Sections 3801 - 3824, classified for federal tax purposes?

(2) In the situation described below, may a taxpayer exchange real property for an interest in a Delaware statutory trust without recognition of gain or loss under Section 1031 of the Internal Revenue Code?

FACTS

On January 1, 2005, A, an individual, borrows money from BK, a bank, and signs a 10-year note bearing adequate stated interest, within the meaning of Section 483. On January 1, 2005, A uses the proceeds of the loan to purchase Blackacre, rental real property. The note is secured by Blackacre and is nonrecourse to A.

Immediately following A's purchase of Blackacre, A enters into a net lease with Z for a term of 10 years. Under the terms of the lease, Z is to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, Z is to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Z may sublease Blackacre. Z's rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or an objective index, such as an escalator clause based upon the Consumer Price Index, but adjustments to the rate or index are not within the control of any of the parties to the lease. Z's rent is not contingent on Z's ability to lease the property or on Z's gross sales or net profits derived from the property.

Also on January 1, 2005, A forms DST, a Delaware statutory trust described in the Delaware Statutory Trust Act, Del. Code Ann. title 12, Sections 3801 - 3824, to hold property for investment. A contributes Blackacre to DST. Upon contribution, DST assumes A's rights and obligations under the note with BK and the lease with Z. In accordance with the terms of the note, neither DST nor any of its beneficial owners are personally liable to BK on the note, which continues to be secured by Blackacre.

The trust agreement provides that interests in DST are freely transferable. However, DST interests are not publicly traded on an established securities market. DST will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre, but will not terminate on the

bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trust agreement further provides that interests in DST will be of a single class, representing undivided beneficial interests in the assets of DST.

Under the trust agreement, the trustee is authorized to establish a reasonable reserve for expenses associated with holding Blackacre that may be payable out of trust funds. The trustee is required to distribute all available cash less reserves quarterly to each beneficial owner in proportion to their respective interests in DST. The trustee is required to invest cash received from Blackacre between each quarterly distribution and all cash held in reserve in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. In addition to the right to a quarterly distribution of cash, each beneficial owner has the right to an in-kind distribution of its proportionate share of trust property.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law. The trust agreement further provides that the trustee may engage in ministerial activities to the extent required to maintain and operate DST under local law.

On January 3, 2005, B and C exchange Whiteacre and Greenacre, respectively, for all of A's interests in DST through a qualified intermediary, within the meaning of Section 1.1031(k)-1(g). A does not engage in a Section 1031 exchange. Whiteacre and Greenacre were held for investment and are of like kind to Blackacre, within the meaning of Section 1031.

Neither DST nor its trustee enters into a written agreement with A, B, or C, creating an agency relationship. In dealings with third parties, neither DST nor its trustee is represented as an agent of A, B, or C.

BK is not related to A, B, C, DST's trustee or Z within the meaning of Section 267(b) or Section 707(b). Z is not related to B, C, or DST's trustee within the meaning of Section 267(b) or Section 707(b).

LAW

Delaware law provides that a Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners. A Delaware statutory trust is created by executing a governing instrument and filing an executed certificate of trust. Creditors of the beneficial owners of a Delaware statutory trust may not assert claims directly against the property in the trust. A Delaware statutory trust may sue or be sued, and property held in a Delaware statutory trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a Delaware statutory trust are entitled to the same limitation on personal liability because of actions of the Delaware statutory trust that is extended to stockholders of Delaware corporations. A Delaware statutory trust may merge or consolidate with or into one or more statutory entities or other business entities.

Section 671 provides that, where the grantor or another person is treated as the owner of any portion of a trust (commonly referred to as a "grantor trust"), there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that the items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that, for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Under Section 1.671-2(e)(3), the term "grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in Section 301.7701-4(c).

Under Section 677(a), the grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed, or held or accumulated for future distribution, to the grantor or the grantor's spouse.

A person that is treated as the owner of an undivided fractional interest of a trust under subpart E of part I, subchapter J of the Code (Â§ Â§ 671 and following), is considered to own the trust assets attributable to that undivided fractional interest of the trust for federal income tax purposes. See Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 85-45, 1985-1 C.B. 183; and Rev. Rul. 85-13, 1985-1 C.B. 184. See also Section 1.1001-2(c), Example 5.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of the unincorporated organization, exclude such organization from the application of all or part of subchapter K, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income and the organization is availed of (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.

Section 1.761-2(a)(2) provides the requirements that must be satisfied for participants in the joint purchase, retention, sale, or exchange of investment property to elect to be excluded from the application of the provisions of subchapter K. One of these requirements is that the participants own the property as coowners.

Section 1031(a)(1) 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 such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(2) provides that Section 1031(a) does not apply to any exchange of stocks, bonds or notes, other securities or evidences of indebtedness or interest, interests in a partnership, or certificates of trust or beneficial interests. It further provides that an interest in a partnership that has in effect a valid election under Â§ 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of the partnership and not as an interest in a partnership.

Under Section 301.7701-1(a)(1) of the Procedure and Administration Regulations, whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes. See Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943); Zmuda v. Comm'r, 731 F.2d 1417 (9th Cir. 1984); Boca Investerings P'ship v. United States, 314 F.3d 625 (D.C. Cir. 2003); Saba P'ship v. Comm'r, 273 F.3d 1135 (D.C. Cir. 2001); ASA Investerings P'ship v. Comm'r, 201 F.3d 505 (D.C. Cir. 2000); Markosian v. Comm'r, 73 T.C. 1235 (1980).

Section 301.7701-2(a) defines the term "business entity" as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Section 301.7701- 3) that is not properly classified as a trust under Â§ 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded.

Section 301.7701-3(a) provides that an eligible entity can elect its classification for federal tax purposes. Under Â§ 301.7701-3(b)(1), unless the entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-4(a) provides that the term "trust" refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries. Usually the beneficiaries of a trust do no more than accept the benefits thereof and are not voluntary planners or creators of the trust arrangement. However, the beneficiaries of a trust may be the persons who create it, and it will be recognized as a trust if it was created for the purpose of protecting and conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

Section 301.7701-4(b) provides that there are other arrangements known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but that are not classified as trusts for federal tax purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through business organizations that are classified as corporations or partnerships.

Section 301.7701-4(c)(1) provides that an "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. See Comm'r v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders.

A power to vary the investment of the certificate holders exists where there is a managerial power, under the trust instrument, that enables a trust to take advantage of variations in the market to improve the investment of the investors. See Comm'r v. North American Bond Trust, 122 F.2d at 546.

Rev. Rul. 75-192, 1975-1 C.B. 384, discusses the situation where a provision in the trust agreement requires the trustee to invest cash on hand between the quarterly distribution dates. The trustee is required to invest the money in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. Rev. Rul. 75- 192 concludes that, because the restrictions on the types of permitted investments limit the trustee to a fixed return similar to that earned on a bank account and eliminate any opportunity to profit from market fluctuations, the power to invest in the specified kinds of short-term investments is not a power to vary the trust's investment.

Rev. Rul. 78-371, 1978-2 C.B. 344, concludes that a trust established by the heirs of a number of contiguous parcels of real estate is an association taxable as a corporation for federal tax purposes where the trustees have the power to purchase and sell contiguous or adjacent real estate, accept or retain contributions of contiguous or adjacent real estate, raze or erect any building or structure, make any improvements to the land originally contributed, borrow money, and mortgage or lease the property. Compare Rev. Rul. 79-77, 1979-1 C.B. 448 (concluding that a trust formed by three parties to hold a single parcel of real estate is classified as a trust for federal income tax purposes when the trustee has limited powers that do not evidence an intent to carry on a profit making business).

Rev. Rul. 92-105, 1992-2 C.B. 204, addresses the transfer of a taxpayer's interest in an Illinois land trust under Section 1031. Under the facts of the ruling, a single taxpayer created an Illinois land trust and named a domestic corporation as trustee. Under the deed of trust, the taxpayer transferred legal and equitable title to real property to the trust, subject to the provisions of an accompanying land trust agreement. The land trust agreement provided that the taxpayer retained exclusive control of the management, operation, renting, and selling of the real property, together with an exclusive right to the earnings and proceeds from the real property. Under the agreement, the taxpayer was required to file all tax returns, pay all

taxes, and satisfy any other liabilities with respect to the real property. Rev. Rul 92-105 concludes that, because the trustee's only responsibility was to hold and transfer title at the direction of the taxpayer, a trust, as defined in Section 301.7701-4(a), was not established. Moreover, there were no other arrangements between the taxpayer and the trustee (or between the taxpayer and any other person) that would cause the overall arrangement to be classified as a partnership (or any other type of entity). Instead, the trustee was a mere agent for the holding and transfer of title to real property, and the taxpayer retained direct ownership of the real property for federal income tax purposes.

ANALYSIS

Under Delaware law, DST is an entity that is recognized as separate from its owners. Creditors of the beneficial owners of DST may not assert claims directly against Blackacre. DST may sue or be sued, and the property of DST is subject to attachment and execution as if it were a corporation. The beneficial owners of DST are entitled to the same limitation on personal liability because of actions of DST that is extended to stockholders of Delaware corporations. DST may merge or consolidate with or into one or more statutory entities or other business entities. DST is formed for investment purposes. Thus, DST is an entity for federal tax purposes.

Whether DST or its trustee is an agent of DST's beneficial owners depends upon the arrangement between the parties. The beneficiaries of DST do not enter into an agency agreement with DST or its trustee. Further, neither DST nor its trustee acts as an agent for A, B, or C in dealings with third parties. Thus, neither DST nor its trustee is the agent of DST's beneficial owners. Cf. Comm'r v. Bollinger, 485 U.S. 340 (1988).

This situation is distinguishable from Rev. Rul. 92-105. First, in Rev. Rul. 92-105, the beneficiary retained the direct obligation to pay liabilities and taxes relating to the property. DST, in contrast, assumed A's obligations on the lease with Z and on the loan with BK, and Delaware law provides the beneficial owners of DST with the same limitation on personal liability extended to shareholders of Delaware corporations. Second, unlike A, the beneficiary in Rev. Rul. 92-105 retained the right to manage and control the trust property.

Issue 1. Classification of Delaware Statutory Trust

Because DST is an entity separate from its owner, DST is either a trust or a business entity for federal tax purposes. To determine whether DST is a trust or a business entity for federal tax purposes, it is necessary, under Â§ 301.7701-4(c)(1), to determine whether there is a power under the trust agreement to vary the investment of the certificate holders.

Prior to, but on the same date as, the transfer of Blackacre to DST, A entered into a 10-year nonrecourse loan secured by Blackacre. A also entered into the 10-year net lease agreement with Z. A's rights and obligations under the loan and lease were assumed by DST. Because the duration of DST is 10 years (unless Blackacre is disposed of prior to that time), the financing and leasing arrangements related to Blackacre that were made prior to the inception of DST are fixed for the entire life of DST. Further, the trustee may only invest in short-term obligations that mature prior to the next distribution date and is required to hold these obligations until maturity. Because the trust agreement requires that any cash from Blackacre, and any cash earned on short-term obligations held by DST between distribution dates, be distributed quarterly, and because the disposition of Blackacre results in the termination of DST, no reinvestment of such monies is possible.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law.

This situation is distinguishable from Rev. Rul. 78-371, because DST's trustee has none of the powers described in Rev. Rul. 78-371, which evidence an intent to carry on a profit making business. Because all of the interests in DST are of a single class representing undivided beneficial interests in the assets of DST and DST's trustee has no power to vary the investment of the certificate holders to benefit from variations in the market, DST is an investment trust that will be classified as a trust under Section 301.7701-4(c)(1).

Issue 2. Exchange of Real Property for Interests under Section 1031

B and C are treated as grantors of the trust under Section 1.671-2(e)(3) when they acquire their interests in the trust from A. Because they have the right to distributions of all trust income attributable to their undivided fractional interests in the trust, B and C are each treated, by reason of Section 677, as the owner of an aliquot portion of the trust and all income, deductions, and credits attributable to that portion are includible by B and C under Â§ 671 in computing their taxable income. Because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for federal income tax purposes, B and C are each considered to own an undivided fractional interest in Blackacre for federal income tax purposes. See Rev. Rul. 85-13.

Accordingly, the exchange of real property by B and C for an interest in DST through a qualified intermediary is the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust or beneficial interest under Section 1031(a)(2)(E). Because Whiteacre and Greenacre are of like kind to Blackacre, and provided the other requirements of Section 1031 are satisfied, the exchange of real property for an interest in DST by B and C will qualify for nonrecognition of gain or loss under Section 1031. Moreover, because DST is a grantor trust, the outcome to the parties will remain the same, even if A transfers interests in Blackacre directly to B and C, and B and C immediately form DST by contributing their interests in Blackacre.

Under the facts of this case, if DST's trustee has additional powers under the trust agreement such as the power to do one or more of the following: (i) dispose of Blackacre and acquire new property; (ii) renegotiate the lease with Z or enter into leases with tenants other than Z; (iii) renegotiate or refinance the obligation used to purchase Blackacre; (iv) invest cash received to profit from market fluctuations; or (v) make more than minor non-

structural modifications to Blackacre not required by law, DST will be a business entity which, if it has two or more owners, will be classified as a partnership for federal tax purposes, unless it is treated as a corporation under Section 7704 or elects to be classified as a corporation under Section 301.7701-3. In addition, because the assets of DST will not be owned by the beneficiaries as coowners under state law, DST will not be able to elect to be excluded from the application of subchapter K. See Section 1.761-2(a)(2)(i).

HOLDINGS

(1) The Delaware statutory trust described above is an investment trust, under Section 301.7701-4(c), that will be classified as a trust for federal tax purposes.

(2) A taxpayer may exchange real property for an interest in the Delaware statutory trust described above without recognition of gain or loss under Section 1031, if the other requirements of Section 1031 are satisfied.

DRAFTING INFORMATION

The principal author of this revenue ruling is Christopher L. Trump of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Christopher L. Trump at (202) 622-3070 (not a toll-free call).

LIKE-KIND PROPERTY ISSUES

HOW LONG TO HOLD (ARTICLE)

IRC §1031 states that property "held for productive use in a trade or business or for investment" must be exchanged for like-kind property. There is much confusion and misinformation among real estate agents and investors on the issue of what is viewed as "held for investment." Most of this confusion stems from the fact that neither the IRS nor the Regulations provide a comprehensive definition of the phrase "held for investment." (The regulations do state, however, that unproductive real estate held by a non-dealer for future use or future appreciation, is held for investment.)

A MORE COMPLETE PERSPECTIVE

There is no safe holding period for property to automatically qualify as being "held for investment."

To qualify for a 1031 exchange, a taxpayer must be able to support that their "intent" at the time of the purchase was to hold the property for investment.

Time is only one factor at which the IRS looks in determining the Exchanger's intent for both the relinquished and replacement properties. The IRS may look at all the facts and circumstances of an investor's situation to determine the Exchanger's true intent for acquiring, holding, and selling properties involved in an exchange. Ideally, an investor would have a variety of ways to support that their intent was to hold for investment purposes. If the investor has the intent to resell the property for a profit within a short amount of time, and not to hold for long-term investment, then the exchange will probably not qualify for deferral. Please see Asset Preservation article entitled "Property Held for Sale" Issues (31) to review more of the factors the IRS talks out to determine whether property is being held primarily for investment vs. for sale.

TWO ADDITIONAL PERSPECTIVES

In one private letter ruling (PLR 8429039), the IRS stated that a minimum holding period of two years would be sufficient. Although a private letter ruling does not establish legal precedent for all investors, there are many advisors who believe two years is a conservative holding period, provided no other significant factors contradict the investment intent.

Other advisors recommend that Exchangers hold property for a minimum of at least twelve months. The reason for this is twofold: (1) A holding period of 12 or more months means the investor will usually reflect it as an investment property in two tax filing years. (2) In 1989, Congress had proposed a one year holding period. Although this proposal was never incorporated into the tax code, some believe it represents a reasonable minimum guideline.

The investor's "intent" in holding both the relinquished and replacement properties is the central issue. Each Exchanger and their advisors should be able to substantiate properties relinquished and acquired in a tax deferred exchange were "held for investment."

JOSEPH R. BOLKER V. COMMISSIONER, CITE AS 56 AFTR 2D 85-5121 (760 F.2D 1039)

Case Information:	
Code Sec(s):	7482
Court Name:	U.S. Court of Appeals, Ninth Circuit,
Docket No.:	No. 84-7357,
Date Decided:	05/17/1985
Prior History:	81 TC 782(No. 48)(opinion by Wilbur,*J.*) affirmed.
Tax Year(s):	Years 1972, 1973.
Disposition:	Decision for Taxpayer.
Cites:	56 AFTR 2d 85-5121, 760 F2d 1039, 85-1 USTC P 9400.

Richards, Watson, Dreyfuss & Gershon, Gilbert Dreyfuss, Los Angeles, Calif., Attys. for Appellee.
Raymond Hepper, Atty., Dept. of Justice, Wash., D.C., for Appellant.
On appeal from the United States Tax Court.

Before BOOCHEVER and BEEZER, Circuit Judges, and HARDY,[*] District Judge.
Judge: BOOCHEVER, Circuit Judge:

Opinion

Bolker was the sole shareholder of the Crosby Corporation (Crosby) which owned the Montebello property. For tax purposes associated with the anticipated development of the property, Bolker decided to liquidate Crosby and distribute Montebello to himself. Before Crosby carried out the liquidation, problems in financing convinced Bolker to dispose of the Montebello property rather than developing it himself. On the day the Crosby liquidation actually occurred, Bolker contracted to exchange Montebello with Southern California Savings & Loan (SCS) for other like-kind investment property to be designated. This exchange took place three months later. Bolker asserted, and the Tax Court agreed, that the exchange qualified for nonrecognition [pg. 85-5122] treatment under I.R.C. §1031(a). [1] Bolker v. Commissioner, 81 T.C. 782 (1983). The Commissioner appeals. Because we believe that Bolker held the Montebello property for investment within the meaning of section 1031(a), we affirm.

The transaction was consummated as follows. In March 1972, Bolker commenced the liquidation of Crosby. On March 13, 1972, all of the following occurred:

((1)) Crosby transferred all its assets and liabilities to Bolker in redemption of all Crosby stock outstanding;
((2)) Bolker as president of Crosby executed the Internal Revenue Service liquidation forms;

((3)) A deed conveying Montebello from Crosby to Bolker was recorded;

((4)) Bolker and Parlex, a corporation formed by Bolker's attorneys to facilitate the exchange, executed a conract to exchange Montebello for properties to be designated by Bolker;

((5)) Parlex contracted to convey Montebello to SCS in coordination with the exchange by Bolker and Parlex; and

((6)) Bolker, Crosby, Parlex, and SCS entered into a settlement agreement dismissing a breach of contract suit pending by Crosby against SCS in the event that all the other transactions went as planned.[2]

On June 30, 1972, all the transactions closed simultaneously, SCS receiving Montebello and Bolker receiving three parcels of real estate which he had previously designated.

Bolker reported no gain on the transaction, asserting that it qualified for nonrecognition under then-current I.R.C. §1031(a):

No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

The Commissioner sent Bolker statutory notices of deficiency on the ground that the transaction did not qualify under section 1031(a). In the Tax Court, the Commissioner argued two theories: that Crosby, not Bolker, exchanged Montebello with SCS, and in the alternative, that Bolker did not hold Montebello for productive use in trade or business or for investment. [3] The Tax Court rejected both arguments. The Commissioner does not appeal the decision that Bolker individually made the exchange. The Commissioner does not challenge any of the Tax Court's findings of fact; review of the Tax Court's decisions of law is de novo. California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 [50 AFTR2d 82-5271] (9th Cir. 1982).

I. Stock For Property

Section 1031(a) specifically excludes from eligibility for nonrecognition an exchange involving stock. The Commissioner argues that Bolker's transactions should properly be viewed as a whole, under the step transaction doctrine, see Commissioner v. Court Holding Co., 324 U.S. 331, 334 [33 AFTR 593] (1945) (court may view transaction as a whole even if taxpayer accomplishes result by series of steps), and that so viewed, Bolker exchanged his Crosby stock for property. The Commissioner did not argue this theory in the Tax Court.

[1] As a general rule, we will not consider an issue raised for the first time on appeal, United States v. Greger, 716 F.2d 1275, 1277 (9th Cir. 1983)(taxpayer argued for first time on appeal that statute prohibiting assistance in preparation of false return cannot apply if preparer is innocent), cert. denied, 104 S. Ct. 1002 (1984), although we have the power to do so, see Hormel v. Helvering, 312 U.S. 552, 557-59 [25 AFTR 1198] (1941). This circuit has recognized three exceptions to this rule: in the "exceptional" case in which review is necessary to prevent a miscarriage of justice or to preserve the integrity of the judicial process, see Greger, 716 F.2d at 1277, when a new issue arises while appeal is pending because of a change in the law, see United States v. Whitten, 706 F.2d 1000, 1012 (9th Cir. 1983) (objection to plain view search first raised on appeal), cert. denied, 104 S. Ct. 1593 (1984), or when the issue presented is purely one of law and either does not depend on the factual record developed below, or the pertinent record has been developed, see United [pg. 85-5123] States v. Patrin, 575 F.2d 708, 712 (9th Cir. 1978) (on appeal of conviction for assaulting federal officers in performance of their duties, government could not rely on a different statute defining federal officers than at trial because defendants might have tried their case differently in response). If one of the exceptions is applicable, we have discretion to address the issue.

The Commissioner contends that the third exception applies in this case. Although a determination based on the step transaction doctrine would require reliance on the factual record, the Commissioner argues that the record is fully developed and that we could decide the issue on appeal without prejudice to Bolker's right at trial to present relevant facts. See id. at 712-13. Application of the step transaction doctrine requires a detailed factual inquiry, however, and there may be facts relevant to the issue which were not developed in the record. Moreover, Bolker's tactics, presentation of the facts, and legal arguments at trial might have been different if the Commissioner had argued the step transaction issue below. [4] We therefore decline to address the issue on appeal.

II. The Holding Requirement

The Commissioner argued unsuccessfully in the Tax Court that because Bolker acquired the property with the intent, and almost immediate contractual obligation, to exchange it, Bolker never held the property for productive use in trade or business or for investment as required by section 1031(a). Essentially, the Commissioner's position is that the holding requirement has two elements: that the taxpayer own the property to make money rather than for personal reasons, and that at some point before the taxpayer decides to exchange the property, he have intended to keep that property as an investment.

Bolker argues that the intent to exchange investment property for other investment property satisfies the holding requirement. Bolker's position also in essence posits two elements to the holding requirement: that the taxpayer own the property to make money, and that the taxpayer not intend to liquidate his investment.

[2] Authority on this issue is scarce. This is not surprising, because in almost all fact situations in which property is acquired for immediate exchange, there is no gain or loss to the acquiring taxpayer on the exchange, as the property has not had time to change in value. Therefore, it is irrelevant to that taxpayer whether section 1031(a) applies. See, e.g., D. Posin, Federal Income Taxation 180 & n.46 (1983); Rev.Rul. 77-297, 1977-2 C.B. 304, 305. The cases generally address the taxpayer's intent regarding the property *acquired* in an exchange, rather than the property*given up.* The rule of those cases, e.g., Regals Realty Co. v. Commissioner, 127 F.2d 931, 933-34 [29 AFTR 444] (2d Cir. 1942), is that at the time of the exchange the taxpayer must intend to keep the property acquired, and intend to do so with an investment purpose. That rule would be nonsense as applied to the property given up, because at the time of the exchange the taxpayer's intent in every case is to give up the property. No exchange could qualify.

The Commissioner cites two revenue rulings to support his position, Rev.Rul. 77-337, 1977-2 C.B. 305, and Rev.Rul. 77-297. Revenue rulings, however, are not controlling. Ricards v. United States, 683 F.2d 1219, 1224 & n.12 [50 AFTR2d 82-6223] (9th Cir. 1981)(revenue rulings not binding although entitled to consideration as "body of experience and informed judgment"). Moreover, neither ruling is precisely on point here. In Revenue Ruling 77-337, A owned X corportion, which owned a shopping center. Pursuant to a prearranged plan, A liquidated X to acquire the shopping center so that he could immediately exchange it with B for like-kind property. A never held the shopping center, and therefore section 1031(a) did not apply. This case differs from 77-337 in two ways. First, the liquidation was planned before any intention to exchange the properties arose, not to facilitate an exchange. Second, Bolker did actually hold Montebello for three months.

In Revenue Ruling 77-297, B wanted to buy A's ranch, but A wanted to exchange rather than sell. A located a desirable ranch owned by C. Pursuant to a prearranged plan, B purchased C's ranch and immediately exchanged it with A for A's [pg. 85-5124] ranch. As to A, the exchange qualifies under section 1031(a). As to B, it does not, since B never held C's ranch, and acquired it solely to exchange. The same distinctions as in 77-337 apply between this ruling and the facts in Bolker. Neither ruling cites case authority for its holdings.

Bolker cites two cases that support his position. In each case, the Tax Court gave section 1031(a) nonrecognition to a transaction in which the property given up was acquired with the intention of exchange. However, neither case actually considered the holding issue, which diminishes the persuasiveness of the authority. In 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975), taxpayer owned an option to purchase real estate. Firemen's Fund Insurance Co. (Firemen's) wanted the property, but taxpayer preferred an exchange to a sale. Firemen's advanced taxpayer the money to exercise its option under a contract providing that taxpayer would exchange the property for property to be acquired by Firemen's. Id. at 8-11. Taxpayer exercised its option, and the exchange was consummated five months later when Firemen's had acquired property satisfactory to taxpayer. Id. at 12. The issue in the case was whether the transaction was the sale of the option to Firemen's, or an exchange of the property with Firemen's. The court held that it was an exchange, and therefore qualified under section 1031(a). Id. at 15. the court apparently never considered whether the fact

that the optioned property was acquired solely for exchange meant that it was held for investment under section 1031(a). Even without an explicit holding, however, the case does support Bolker's theory that an intent to exchange for like-kind property satisfies the holding requirement.
Rutherford v. Commissioner, T.C.M. 1978-505, [¶78,505 P-H Memo TC] 37 T.C.M. (CCH) 1851-77, is an unusual case with a holding similar to 124 Front Street. W, a cattle breeder, agreed with R, another breeder, to exchange W's twelve half-blood heifers for twelve three-quarter blood heifers to be bred from the half-blood heifers. W gave R the twelve half-blood heifers. R bred them to a registered bull and gave W the first twelve three-quarter blood heifers produced. Id. at 1851-77 to 1851-78. At stake in the case were depreciation deductions. En route to determining R's basis in the half-blood heifers for depreciation purposes, the Tax Court held that the exchange of heifers qualified for nonrecognition under section 1031(a). Id. at 1851-79. Although the court did not even mention the point, the facts indicate that when by virtue of their birth R "acquired" the three-quarter blood heifers, the property he gave up, he had already contracted to exchange them. Thus, Rutherford also supports Bolker's position, albeit tacitly.

The Tax Court's holding in this case is based on its recent opinion in Magneson v. Commissioner, 81 T.C. 767 (1983) (court reviewed), aff'd, No. 84-7069 [55 AFTR2d 85-911], (9th Cir. Feb. 20, 1985). In Magneson, taxpayers exchanged property for like-kind property and then by prearrangement contributed the property they acquired to a partnership. Each transaction viewed separately was admittedly tax-free, but in combination raised the issue whether contribution to a partnership satisfies the holding requirement for the acquired property. The Bolker Tax Court interpreted Magneson as holding that an intent to continue the investment rather than selling it or converting it to personal use satisfied the holding requirement, even if the taxpayer never intended to keep the specific property acquired. In both Bolker and Magneson, the Tax Court emphasized the admitted nonrecognition treatment accorded each individual step in the transactions, and reasoned that if each step were tax-free, in combination they should also be tax-free, so long as the continuity of investment principle underlying section 1031(a) is respected. See Bolker, 81 T.C. at 805-06; Magneson, 81 T.C. at 771.

We recently affirmed Magneson but our rationale differed from that of the Tax Court. While we recognized the importance of continuity of investment as the basic purpose underlying section 1031(a), see H.R. Rep. No. 704, 73d Cong., 2d Sess. 12, reprinted in 1939-1 C.B. (pt. 2) 554, 564, we did not hold that that principle justifies the failure to address the specific requirements of section 1031(a). Rather, we based affirmance on our holding that the Magnesons intended to and did continue to hold the acquired property, the contribution to the partnership being a change in the form of ownership rather than the relinquishment of ownership. Magneson, slip op. at 9-13. Thus the Magnesons satisfied the specific requirements of section 1031(a). Nothing in Magneson relieves Bolker of his burden to satisfy the requirement that he have held the property given up, Montebello, for investment.

Finally, there is nothing in the legislative history which either supports or negates Bolker's or the Commissioner's position. In sum, the Commisioner is supported by two revenue rulings which are neither controlling nor precisely on point. Bolker is supported by two Tax Court decisions which [pg. 85-5125] did not explicitly address this issue. In the absence of controlling precedent, the plain language of the statute itself appears our most reliable guide.

The statute requires that the property be "held for productive use in trade or business or for investment." Giving these words their ordinary meaning, see Greyhound Corp. v. United States, 495 F.2d 863, 869 [33 AFTR2d 74-1534] (9th Cir. 1974) (if Code does not define term, court should give words their ordinary meaning), a taxpayer may satisfy the "holding" requirement by owning the property, and the "for productive use in trade or business or for investment" requirement by lack of intent either to liquidate the investment or to use it for personal pursuits. These are essentially the two requirements courts have placed on the property acquired in a section 1031(a) exchange, see, e.g., Regals Realty, 127 F.2d at 933-34 (intent to sell disqualifies exchange); Click v. Commissioner, 78 T.C. 225, 233-34 (1982) (intent to give as gift disqualifies exchange), so this interpretation would yield the symmetry the use of identical language seems to demand.

The Commissioner's position, in contrast, would require us to read an unexpressed additional requirement into the statute: that the taxpayer have, previous to forming the intent to exchange one piece of property for a second parcel, an intent to keep the first piece of property indefinitely. We decline to do so. See Starker v. United States, 602 F.2d 1341, 1352-53[44 AFTR2d 79-5525] (9th Cir. 1979) (refusing to read unexpressed additional requirement of simultaneous exchange into §1031(a)). [5] Rather, we hold that if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is "holding" that property "for productive use in trade or business or for investment" within the meaning of section 1031(a). Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement, because it is*not* an intent to liquidate the investment or to use it for personal pursuits. Bolker acquired the Montebello property with the intent to exchange it for like-kind property, and thus he held for investment under section 1031(a). The decision of the Tax Court is therefore Affirmed.

[*]

Honorable Charles L. Hardy, United States District Judge for the District of Arizona, sitting by designation.

[1]

All references to the Internal Revenue Code are to the Internal Revenue Code of 1954 as amended and in force in 1972.

[2]

Crosby had filed a breach of contract suit against SCS in 1971 based upon SCS' failure to fulfill a prior contract to purchase Montebello. We do not discuss whether the settlement of this lawsuit as part of the transaction was an exchange of non-like-kind property, because the Commissioner did not raise the argument at trial or on appeal. See discussion Part I below.

[3]

The Commissioner concedes that the real estate received by Bolker was of like kind to the Montebello property.

[4]

At trial, the Commissioner argued that in substance the exchange of Montebello was negotiated and carried out by the corporation, and that the corporation, not Bolker, should be taxed on any gain realized. The Commissioner's evidence was directed toward proving that the exchange was the

continuation and culmination of the 1969 corporate plan to sell Montebello, disguised as a liquidation and exchange to avoid tax consequences to the corporation. Bolker's evidence was directed toward proving that the corporate plan to sell Montebello had been abandoned, and that the 1971 negotiations were by Bolker as an individual despite the fact that Crosby still owned Montebello.

[5]

Starker's specific holding that section 1031(a) does not require simultaneous exchange, 602 F.2d at 1354-55, has been limited by a revision of section 1031(a). Deficit Reduction Act of 1984, Pub. L. No. 98-369, §77, 98 Stat. 494, 595 (effective July 19, 1984; requiring that property acquired be designated and exchanged within 180 days after taxpayer transfers the property given up). The addition of this requirement, specifically drafted in response to Starker, see H.R. Rep. No. 432, 98th Cong., 2d Sess. 1231, reprinted in 6B 1984 U.S. Code Cong. & Ad. News 1, 201, does not affect the validity of Starker's refusal to read unexpressed requirements into the then-current version of section 1031(a).

DELWIN G. CHASE AND GAIL J. CHASE V. COMMISSIONER, 92 T.C. 874

Case Information: [pg. 874]

Code Sec(s):	453
Docket:	Docket No. 7562-86.
Date Issued:	04/24/1989
Judge:	Opinion by FAY, *J.*
Tax Year(s):	Year 1980.
Disposition:	Deficiencies redetermined.

Counsel

Neil F. Horton, James G. Roberts, for the petitioners.[pg. 875]
Rebecca T. Hill, Susan J. Adler, and *Bryce A. Kranzthor,* for the respondent.
Fay, *Judge:*

Respondent determined a deficiency in petitioners' Federal income tax for the 1980 taxable year in the amount of $1,074,874. After concessions, the following issues are presented for decision:

(1) Did petitioners satisfy section 1031[1] on the disposition of the John Muir Apartments?

(2) Are petitioners entitled to a short-term capital loss of $783,762, under section 731(a)(2), with respect to the receipt of $929,582 in complete liquidation of a limited partnership interest held by both petitioners?

We hold that, applying the substance over form doctrine, the John Muir Investors, a partnership, rather than petitioners disposed of the John Muir Apartments. Further, we hold that petitioners, as partners of John Muir Investors, are not entitled to the benefits of section 1031 nonrecognition. Further, we hold that petitioners' entitlement to installment sales treatment under section 453 is an untimely raised issue. Finally, we hold that petitioner Gail Chase is entitled to recognize a short-term capital loss in 1980 in connection with her complete liquidation of her entire interest in John Muir Apartments.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulated facts and attached exhibits are incorporated herein by this reference.

Petitioners Delwin G. Chase (Mr. Chase) and Gail J. Chase (Mrs. Chase), resided in Alamo, California, at the time their petition herein was filed. Petitioners filed a joint Federal income tax return for the year at issue.

Disposition of the John Muir Apartments

On January 26, 1978, Mr. Chase formed John Muir Investors (JMI), a California limited partnership. JMI was [pg. 876]formed for the purpose of purchasing, operating and holding the John Muir Apartments, an apartment building located in San Francisco, California (hereinafter referred to as the Apartments), which were purchased by JMI on March 31, 1978, for $19,041,024. Subsequently, Triton Financial Corp. (Triton) was added as a general partner of JMI. Triton was a corporation in which petitioner held a substantial interest. Mr. Chase and Triton were general partners who had the exclusive right to manage JMI.

Pursuant to JMI's limited partnership agreement, once limited partners made contributions to JMI, they were prohibited from receiving distributions of property, other than cash, in liquidation of their capital contributions to JMI. A section of the JMI limited partnership agreement entitled "status of limited partners" provided as follows:

No limited partner shall have the right to withdraw or reduce his invested capital except as a result of the termination of the partnership or as otherwise provided by law. No limited partner shall have the right to bring an action for partition against the partnership. No limited partner shall have the right to demand or receive property other than cash in return for his contribution, and no limited partner shall have priority over any other limited partner either as to the return of his invested capital or as to profit, losses or distribution.

After JMI held the Apartments for approximately 1 year, there developed a high level of speculative interest in San Francisco in purchasing apartment buildings for conversion to condominium units for sale to individuals. This speculative interest caused the value of real estate capable of being converted to condominium units, such as the Apartments, to appreciate. By mid 1979, JMI was attempting to find a buyer for the Apartments.

On January 20, 1980, JMI accepted an offer ("first offer") to purchase the Apartments from an unrelated individual for $28,421,000. Subsequent to JMI's acceptance of the first offer, but prior to the scheduled closing date, petitioners attempted to structure the sale of the Apartments in such a way that they would not have to recognize any taxable gain. To accomplish this, Mr. Chase caused JMI to distribute to himself and his wife a deed to an undivided 46.3527 percent interest in the Apartments in liquidation of petitioners' 46.3527 percent limited partnership interest in JMI.[pg. 877]

Petitioners attempted to structure the subsequent disposition of the Apartments pursuant to the first offer so that, as to them, such disposition would be treated for Federal tax purposes as a nontaxable nonsimultaneous exchange of real property for other real property.

On February 5, 1980, the first offer expired due to the failure of the buyer to deposit funds into escrow by such date as required by the escrow agreement. However, there was a second offer for the purchase of the Apartments on March 21, 1980, at which time an agent of RWT Enterprises, Inc. (RWT), wrote a letter of intent to Triton, one of JMI's two managing general partners, to purchase the Apartments for $26,500,000 (second offer). This letter further stated that any broker's commissions would be paid by Triton. This letter did not indicate that RWT believed, or had been informed, that petitioners, individually, had any ownership interest in the Apartments.

In connection with the second offer, on March 26, 1980, an officer of Triton wrote a letter on behalf of JMI, in Triton's role as a managing general partner of JMI, to a brokerage company. This letter stated that JMI agreed to pay a real estate brokerage commission of $250,000 as a result of the sale to RWT and that this commission was the total commission due. Triton did not mention petitioners' undivided ownership interest in the Apartments, or of any duty by petitioners to pay a pro rata portion of such commission.

In preparing to close the sale, an escrow agreement was executed. Under the heading "seller," the escrow agreement was signed, on behalf of JMI, by Mr. Chase. The escrow agreement was not signed by petitioners on behalf of themselves as individual owners of the Apartments.

On June 12, 1980, when Mr. Chase was certain that the sale to RWT was going to close, he recorded the deed from JMI, executed in January 1980, for petitioners' undivided interest in the Apartments.

Petitioners, as with the first offer, attempted to structure the Apartments' disposition so that it would not be taxable to them. To this end, on June 13, 1980, petitioners entered into a Real Property Exchange Trust Agreement (exchange agreement) with RWT and Dudley Ellis (Mr. Ellis). Mr. Ellis [pg. 878]was a former employee of Mr. Chase who agreed to serve as trustee of a trust (the Ellis Trust), created under the exchange agreement. The exchange agreement was executed in anticipation of the sale of the Apartments to RWT, and provided that RWT, as purchaser of the Apartments, would transfer to the Ellis Trust petitioners' share of the proceeds. Pursuant to the exchange agreement, Mr. Ellis, in his capacity as trustee of the Ellis Trust, agreed to transfer to petitioners "like-kind real property" which Mr. Ellis was to purchase with such proceeds. Specifically, the exchange agreement provided that petitioners would locate and negotiate the terms for the purchase of properties to be "exchanged." Petitioners then instructed Marilyn Lamonte, the escrow officer handling the sale, to pay 46.3527 percent of the "net proceeds" from the sale to Mr. Ellis as trustee under the exchange agreement.

On July 7, 1980, the John Muir Apartments were sold to Traweek Investment Fund No. 10, Ltd. (Traweek), an entity related to, and substituted as buyer by, RWT. The net proceeds of $9,210,876 received from the sale to Traweek were allocated by Lamonte between the Ellis Trust and JMI. The actual payments out of escrow were a check for $3,799,653 to Ellis in his capacity as trustee under the Ellis Trust, and a check for $4,811,223 paid directly to JMI.

Petitioners' instructions to Lamonte, to the effect that Ellis, as trustee, was to be the recipient of 46.3527 percent of "net proceeds" from the sale, were not followed. Rather, the portion of the proceeds distributed to Ellis in trust for petitioners represented an allocation of a distributive share of total net proceeds to petitioners in their capacity as limited partners of JMI in accordance with the terms of the JMI limited partnership agreement and not as a straight allocation of 46.3527 percent of "net proceeds."

From January 1980, until the date of the sale was closed, the expenses of operating the Apartments were paid with funds that were in JMI's operating bank account. Petitioners did not pay, with their own money, any of the expenses from January 1980, when they received a deed to the Apartments through July 7, 1980, the date of sale. Petitioners also did not receive any of the rental income earned during this period, such rent continued to be paid to JMI. [pg. 879]Petitioners' relationship with respect to the Apartments, after they were deeded an undivided interest in such, was in all respects unchanged in relation to their relationship to the Apartments as limited partners of JMI.

On June 30, 1981, Ellis, as trustee of the Ellis Trust, assigned to Creston Corp. (Creston), as successor trustee of the Ellis Trust, petitioners' share of the proceeds from the sale. Creston was, at the time of such assignment, a corporation wholly owned by Ellis.

By July 23, 1982, Triton, as general partner of entities controlled by petitioner, completed the acquisition of the following three properties which were later acquired from Creston by petitioners: (1) The Snug Harbor Apartments in Dallas, Texas (the Snug Harbor property); (2) a ground lease to commercial real property in Orange County, California (the Irvine property); and, (3) certain commercial real estate in Santa Ana, California (the Woodbridge property).

Creston, as trustee under the Ellis Trust, acquired, and immediately transferred to petitioners, the Snug Harbor property on or about October 27, 1982. Petitioners held the Snug Harbor property for 7 months. Creston acquired and then transferred to petitioners, the Irvine property on October 29, 1982. Petitioners, in turn, disposed of the Irvine property on the same date. On October 29, 1982, Creston acquired, and then transferred the Woodbridge property to petitioners, who disposed of the property on the same date. In addition to the above properties, Creston, as trustee under the Ellis Trust, also purchased for petitioners three other properties located in the State of Kentucky.

Liquidation of the Lockwood Interest

On March 5, 1980, petitioners purchased a 2.92-percent limited partnership interest in JMI from Albert and Hazel Lockwood for $230,000 and a 8.78-percent limited partnership interest from Todd and Karen Sue Lockwood for $690,000 (hereinafter referred to collectively as the Lockwood interest). The Lockwood interest was a limited partnership interest in addition to the 46.3527-percent interest previously acquired.

On July 9, 1980, 2 days after the disposition of the Apartments, petitioners received $929,582 in complete liquidation [pg. 880]of their 11.72 percent Lockwood interest. Petitioners reported a short- term capital loss of $783,762 on their 1980 Federal income tax return as a result of this distribution. Petitioners computed their adjusted basis and loss as follows:

Cost of Lockwood interest	$920,000
Distributive share of long-term capital gain reported from the sale of the John Muir Apartments	850,189
Distributive share of operating loss reported	(59,845)
Adjusted basis	1,710,344
Amount realized	926,582
Less adjusted basis	1,710,344
Claimed loss	(783,762)

The $929,582 cash distribution from the liquidation of this 11.72-percent interest liquidated petitioners' entire *limited* partnership interest in JMI held as of this date. Petitioner, however, continued thereafter to hold an interest in JMI as a *general* partner. After this liquidation of the 11.72-percent interest, JMI continued operating as a partnership for the purpose of investing in other real property.

On December 31, 1980, petitioners acquired a 1.31-percent limited partnership interest in JMI from Anthony and Carole Cline.

OPINION

The first issue is whether petitioners met the requirements of section 1031. Section 1031(a) provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment (excluding certain types of property not involved herein) is exchanged solely for property of like-kind. Since the distinction between "trade or business" and "investment" in section 1031(a) is immaterial for our purposes, for convenience, we will use the term "held for investment." Based on a number of theories, respondent contends that petitioners are not entitled to nonrecognition under section 1031(a) or, in the alternative, that petitioners must recognize gain under section 1031(b) to the extent that certain of the property ultimately received by petitioners was not held for investment.[pg. 881]

Respondent contends that section 1031(a) is inapplicable because the disposition of the Apartments was, in substance, a sale by JMI, and not an exchange by petitioners of like-kind property. Petitioners contend that we must respect the form in which they structured the disposition of the Apartments, and that such form satisfied the requirements of section 1031(a).

To qualify for nonrecognition, a taxpayer must satisfy each of the specific requirements as well as the underlying purpose of section 1031(a).*Bolker v. Commissioner,* 760 F.2d 1039, 1044 (9th Cir. 1985), affg. 81 T.C. 782 (1983). We must determine whether the "exchange" requirement of that section was satisfied. Respondent argues that the substance over form doctrine is applicable to impute the disposition of the Apartments entirely to JMI and concludes that, in substance, petitioners did not "exchange" any part of the Apartments.

The substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction. *Commissioner v. Court Holding Co.,* 324 U.S. 331 (1945); *United States v. Cumberland Public Service Co.,* 338 U.S. 451 (1950). In determining substance, we must look beyond the "superficial formalities of a transaction to determine the proper tax treatment."*Blueberry Land Co. v. Commissioner,* 361 F.2d 93, 101 (5th Cir. 1966), affg. 42 T.C. 1137 (1964). "Transactions, which did not vary, control, or change the flow of economic benefits, are dismissed from consideration."*Higgins v. Smith,* 308 U.S. 473, 476 (1940). We hold that the substance over form doctrine applies and that, in substance, JMI disposed of the Apartments.

Although the general partners of JMI caused JMI to prepare a deed conveying an undivided 46.3527-percent interest in the Apartments to petitioners, at no time did petitioners act as owners except in their roles as partners of JMI. Petitioners were deeded an undivided interest at the time of the first offer because it appeared that a sale was imminent. When this sale failed to close, however, petitioners' deed remained unrecorded until shortly before the disposition in question. There is no indication that any party to the sale believed that anyone other than JMI held[pg. 882] title at the time of RWT's offer to purchase. Further, there is no evidence of negotiations by petitioners on behalf of themselves concerning the terms for the disposition of the Apartments. Also, petitioners never paid any of the operating costs of the Apartments or their share of the brokerage commission. Further, petitioners did not receive, or have credited to them, any of the Apartment's rental income.

Equally important, in apportioning the net sale proceeds, all parties ignored petitioners' purported interest as direct owners. Rather, petitioners received only their distributive share of JMI's net proceeds as limited partners. In addition, the JMI limited partnership agreement provided that no limited partner could demand and receive property *other than cash* from the partnership. Further, there is no evidence that petitioners were otherwise authorized by the other limited partners to receive a share of the Apartments as a partnership distribution or that the other limited partners were even aware that such a distribution had occurred. We can only conclude that petitioners' failure to respect the form in which they cast this transaction by failing to receive their share of proceeds as direct owners was caused by petitioners' realization that they were not direct owners and could not be so by virtue of the partnership agreement.

Petitioners final argument regarding the substance issue is that JMI's general partners acted as petitioners' agents in negotiating the disposition of the John Muir Apartments to Traweek. This, petitioners argue, explains why they did not appear, individually, as parties in most of the documents to this transaction. We find petitioners' argument, in this regard, both self-serving and unsupported by the record.

Having determined that, in substance, JMI disposed of the Apartments, we must determine whether petitioners are entitled to "exchange" treatment under section 1031(a), which treatment would flow through JMI to all partners in accordance with their distributive share of partnership gain. Sec.

702(a). Petitioners are entitled to nonrecognition of gain under section 1031(a), as a partner of JMI, if JMI has satisfied the requirements of section 1031(a) in disposing of the Apartments.[pg. 883]

Section 1031(a) requires that like-kind property be both given up and received in the "exchange." Here, it is clear that JMI transferred investment property but did not receive like-kind property in "exchange." This is because JMI never held the properties that were ultimately received by petitioners as part of the purported "exchange." Accordingly, JMI never "exchanged" like-kind property.

Having concluded that JMI sold the entire interest in the Apartments, and that JMI did not act as petitioner's agent with respect to an undivided interest in such apartment, we hold that petitioners failed to "exchange" like-kind property within the meaning of section 1031(a). Accordingly, petitioners are not entitled to the benefits of that section. [2]

Petitioners argue, alternatively, for the first time on brief, that if section 1031(a) is inapplicable, they now be allowed to elect installment sale treatment under section 453. Petitioners cite *Bayley v. Commissioner,* 35 T.C. 288 (1960), wherein we permitted a taxpayer to elect, in an amended petition, the installment method under section 453, where the issue of nonrecognition under section 1034 was decided adversely to the taxpayer. Petitioners' argument fails for two reasons. First, petitioners did not amend their pleadings or raise such issue at trial, but only raised such issue on brief. See *Seligman v. Commissioner,* 84 T.C. 191 (1985) affd. 796 F.2d 116 (5th Cir. 1986); *Markwardt v. Commissioner,* 64 T.C. 989 (1975). Second, since we find that JMI disposed of the Apartments, the election under section 453 can only be made by the partnership. See sec. 703(b); *Rothenberg v. Commissioner,* 48 T.C. 369 (1967). Accordingly, we hold petitioners are not entitled to elect installment sale treatment under section 453.

The final issue is whether petitioners are entitled to claim a short-term capital loss of $783,762 under section 731(a)(2) in connection with their receipt of $929,582 in complete liquidation of their Lockwood limited partnership interest on July 9, 1980. This issue is raised because petitioner held a general partnership interest in JMI throughout 1980 and petitioners subsequently reacquired a limited partnership in JMI on December 31, 1980. The general rule contained in section 731(a)(2) is that a partner may not recognize a loss [pg. 884]from a partnership distribution. Section 731(a)(2) provides an exception to the general rule of nonrecognition, however, if certain requirements are met. First, the distribution must be "in liquidation of a partner's interest in a partnership." Second, no property other than money, unrealized receivables (as defined in section 751(c)), or inventory (as defined in section 751(d)(2)) must be received in the liquidating distribution. Third, a loss must be realized. See sec. 731(a)(2).

With respect to the first requirement, both parties refer to section 761(d). That section defines, for purposes of subchapter K, the term "liquidation of a partner's interest" as "the termination of a partner's*entire* interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership." (Emphasis added.) Respondent argues that under section 761(d), in order to terminate one's "entire interest" in a partnership, one must terminate both his general and limited partnership interests. Petitioners argue that section 761(d) only requires the termination of either the entirety of one's limited partnership interest or one's general partnership interest. Petitioners further argue that the retention of one's general partnership interest does not prevent, under section 731(a)(2), the recognition of a loss upon the termination of one's entire limited partnership interest.

We find, however, that petitioners' argument ignores the plain meaning of the statute which is unambiguous on its face. Section 761(d) provides that the term "liquidation of a partner's interest" means the termination of a partner's entire interest by means of a distribution, or a series of distributions, to the partner by the partnership. When petitioners liquidated their Lockwood interest, Mr. Chase still retained an interest in JMI as a general partner and, therefore, he did not liquidate his "entire interest" in JMI. As to Mrs. Chase, she no longer was a partner in JMI after the distribution in liquidation of the Lockwood interest. Although, as noted by respondent, she became a limited partner in JMI on December 31, 1980, she no longer had any interest in JMI, as of July 9, 1980.

Respondent argues that no loss can be realized because petitioners received nonqualifying property (46.3527-percent [pg. 885]interest in the Apartments), as opposed to money, unrealized receivables, or inventory, as part of a series of liquidating distributions, and that petitioners are thus disqualified from realizing a loss. It is unnecessary to reach this argument since we previously held herein that the distribution to petitioners of an interest in the Apartment was, for Federal tax purposes, illusory. Accordingly, we hold that petitioner Gail Chase is entitled to a short term capital loss.

To reflect the foregoing.

Decision will be entered under Rule 155.

[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] We do not address respondent's alternative arguments, as those arguments are moot.

NORMAN J. MAGNESON AND BEVERLY G. MAGNESON v. COMMISSIONER, 81 T.C. 767

Case Information:

Code Sec(s):	1031
Docket:	Docket No. 28473-81.
Date Issued:	10/20/1983
Judge:	Opinion by GOFFE, *J.*
Tax Year(s):	Year 1977.
Disposition:	Decision for taxpayer.

Counsel

Thomas W. Bettles, for the petitioners.
Kevin M. Bagley, for the respondent.

OPINION

Goffe, *Judge*:

The Commissioner determined a deficiency in petitioners' Federal income tax for the taxable year 1977 in the amount of $19,563. The sole issue for decision is whether the exchange of petitioners' fee simple interest in real property [pg. 768]for a 10-percent undivided interest in other real property followed immediately by contribution of the 10-percent interest to a partnership for a 10-percent interest therein qualifies for nonrecognition treatment under section 1031(a).[1]

This case was submitted fully stipulated pursuant to Rule 122 of the Tax Court Rules of Practice and Procedure. The facts and exhibits are incorporated herein by this reference.

Petitioners, husband and wife, resided in San Diego, Calif., when they filed their petition in this case.

Prior to August 11, 1977, petitioners were the sole owners of a free simple interest in real property and an apartment building located at 4060 Iowa Street, San Diego, Calif. (Iowa Street Property), which was held by them at all times for productive use in trade or business or for investment within the meaning of section 1031(a).

Prior to August 11, 1977, N.E.R. Plaza, Ltd. (N.E.R.), a limited partnership under California law, was the owner of commercial property located at 2251 San Diego Avenue, San Diego, Calif., known as the Plaza Property (Plaza Property) which the partnership was organized to acquire, own, maintain, and operate.

Pursuant to a prearranged transaction consummated on August 11, 1977, petitioners transferred their fee interest in Iowa Street Property to N.E.R. solely in exchange for a 10-percent undivided interest in Plaza Property. Thereafter, on the same day, they contributed cash and their undivided interest in Plaza Property to U.S. Trust Ltd. (U.S. Trust) for a general partnership interest consisting of a 10-percent capital (equity ownership) interest and a 9-percent interest in net profits and losses. U.S. Trust was a limited partnership under California law. The remaining 90-percent undivided interest in Plaza Property was acquired by U.S. Trust on the same day. It is undisputed that the contribution of petitioners' interest in Plaza Property and cash to U.S. Trust for their general partnership interest is nontaxable under the provisions of section 721.[pg. 769]

It is agreed by the parties that petitioners' interests in Iowa Street Property and Plaza Property are properties of a like kind within the meaning of section 1031(a).

The Commissioner determined that the exchange of Iowa Street Property for Plaza Property did not qualify for nonrecognition under section 1031(a) because petitioners did not *hold* Plaza Property for productive use in trade or business or for investment as required by section 1031(a). The distinction between "trade or business" and "investment" is immaterial for our purposes, so for convenience, we will use the term "held for investment." Sec. 1.1031(a)-1, Income Tax Regs.

We have previously decided that if a taxpayer holds the property received in a "like-kind" exchange for sale, the taxpayer does not hold the property for investment and, therefore, is not entitled to the benefits of nonrecognition under section 1031(a). *Regals Realty Co. v. Commissioner,* 43 B.T.A. 194 (1940), affd. 127 F.2d 931 (2d Cir. 1942). We have also decided that if a taxpayer holds the property received in a like-kind exchange for the purpose of making gifts, the taxpayer is deemed not to hold it for investment and, thus, is not entitled to nonrecognition treatment under section 1031(a). *Click v. Commissioner,* 78 T.C. 225 (l982). On the other hand, we have decided that if a taxpayer holds the property for investment, even though he contemplates eventually passing it to his children, his holding under such circumstances is acceptable within the requirement of section 1031(a). *Wagensen v. Commissioner,* 74 T.C. 653 (1980).

Petitioners did not hold Plaza Property for sale, personal use, or for transfer as a gift. Rather, petitioners held Plaza Property for making a nontaxable contribution of it to U.S. Trust; hence, we must decide whether such "holding" qualifies for holding as an investment.

Section 1.1000-1, Income Tax Regs., provides that gain or loss realized from the exchange of property *differing materially either in kind or in extent* is treated as income or as loss sustained.

Section 1.1002-1, Income Tax Regs.,[2] provides as follows:[pg. 770]

Section 1.1002-1. Sales or exchanges.

(a) *General rule.* The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Code provide otherwise.

(b) *Strict construction of exceptions from general rule.*The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) *the underlying purpose for which such exchange is excepted from the general rule.* The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, and 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular *differences exist between the property parted with and the property acquired, but such differences are more formal than substantial.* As to these, the Code provides that *such differences shall not be deemed controlling,* and that gain or loss shall not be recognized at the time of the exchange. *The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated*; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

[Emphasis added.]

The principle embodied in the regulations, i.e., that to qualify for nonrecognition, the new property is substantially a continuation of the old investment still unliquidated, springs from the committee reports covering the predecessor of section [pg. 771]1031(a). H. Rept. 704, 73d Cong., 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 564. *Wagensen v. Commissioner, supra* at 658.

In *Koch v. Commissioner,* 71 T.C. 54, 63-64 (1978), we explained:

The basic reason for allowing nonrecognition of gain or loss on the exchange of like-kind property is that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the transaction occurred. "[I]f the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit." *** The rules of section 1031 apply automatically; they are not elective. *** The underlying assumption of section 1031(a) is that the new property is substantially a continuation of the old investment still unliquidated. ***

Section 1.1031(a)-1(a), Income Tax Regs., refers to section 1.1002, Income Tax Regs. Applying the rationale of the regulations, committee reports, and case law to the instant case, the "holding question" should be resolved by deciding whether the contribution of Plaza Property to U.S. Trust was a liquidation of petitioners' investment or a continuation of the old investment unliquidated in a modified form. We conclude that it is the latter.

The contribution of Plaza Property to U.S. Trust admittedly is a nontaxable transaction under section 721 which, together with section 1031(a), is unequivocally described above in section 1.1002-1, Income Tax Regs., as representing a continuation of the old investment, not a liquidation.

Other provisions treat a contribution of property to a partnership under section 721 as a change in form but not a liquidation of the investment. First, there is no recapture of the investment credit when property is contributed to a partnership because such a transfer is not a "disposition" but is, instead, a *mere change in the form of doing business.* Sec. 47(a)(1); sec. 1.47-3(f), Income Tax Regs. "Formal" differences in the property parted with and the property acquired are not controlling. Sec. 1.1002, Income Tax Regs., quoted in full, *supra.* This rule also applies to both property held for the production of income and property used in a trade or business. Sec. 1.47-3(f)(3), Income Tax Regs. Second, a contribution of "section 1245 property" to a partnership does not require the application of section 1245. Sec. 1.1245-4(c)(2)(vi), Income Tax Regs. Nor does the contribution of "section 1250 property" to a[pg. 772] partnership require the application of section 1250. Sec. 1250(d) and sec. 1.1250-1(c)(2), Income Tax Regs.[3] Finally, the contribution of an installment obligation to a partnership under section 721 does not accelerate reporting of the entire gain or loss resulting from a disposition of an installment obligation under section 453. Sec. 1.453-9(c)(2), Income Tax Regs.

Further, we note that section 1033 is not listed in section 1.1002-1(c), Income Tax Regs., quoted above because an involuntary conversion is not an exchange but is, instead, more akin to a sale, the gain from which is not recognized if the proceeds are used to purchase property similar or related in service or use. It is true, that in determining whether the replacement property is similar or related in service or use to the real property converted, reference is made to the "like kind" provision of section 1.1031(a)-1(b), Income Tax Regs. Sec. 1.1033(g)-1(a), Income Tax Regs. Section 721, however, has no requirement of "like kind"; the contribution to the partnership is not a sale; and there is no issue of "like kind" in the instant case. See *M.H.S. Co. v. Commissioner,* 575 F.2d 1177 (6th Cir. 1978), affg. a Memorandum Opinion of this Court.

As further support for the proposition that petitioners merely effected a change in the form of the ownership of their investment instead of liquidating their investment, it must be pointed out that U.S. Trust's basis in the Plaza Property for computing gain or loss is petitioners' basis, i.e., their cost basis in Iowa Street. [4] U.S. Trust "tacks on" to petitioners' holding period for Plaza Property pursuant to section 1223(2), and the Commissioner has acknowledged that it is the partnership's holding period with respect to the property, rather than the partner's holding period for his partnership interest, which determines whether the gain or loss is long term or short term. Rev.Rul. 68-79, 1968-1 C.B. 310.

Although not controlling, under the facts in the instant case, if U.S. Trust were liquidated before it disposed of Plaza Property, petitioners would receive a 10-percent interest—identical [pg. 773]with the interest they held prior to their contribution of Plaza Property to U.S. Trust. Similarly, if Plaza Property were sold by U.S. Trust, petitioners would be taxable upon 9 percent of the proceeds of the identical long- or short-term capital gain realized which would, instead, be 10 percent of the same amount if they had sold Plaza Property individually instead of contributing it to U.S. Trust. [5]

Plaza Property was stipulated by the parties to be "commercial property." N.E.R. was organized to "acquire, own, maintain and operate" Plaza Property. If petitioners had not contributed Plaza Property to U.S. Trust, they might, nevertheless, be taxable as a partnership together with the other owners of undivided interests depending upon the level of their activity. Section 301.7701-3(a), Proced. & Admin. Regs., provides in part as follows:

Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

This demonstrates that, for tax purposes, joint ownership of the property and partnership ownership of the property are merely formal differences and not substantial differences as set forth in section 1.1002(c), Income Tax Regs., and petitioners did not liquidate their investment in Plaza Property when they contributed it to U.S. Trust.

On brief, petitioners argue that respondent "has taken certain unreasonable actions which entitle petitioners to interest payment relief, legal fees, or such other relief as may be determined appropriate by the Court." With respect to this case, which was submitted fully stipulated on November 18, [pg. 774]1982, this Court does not have jurisdiction to award interest (*American Rolbal Corp. v. Commissioner,* 220 F.2d 749 (2d Cir. 1955), affg. a Memorandum Opinion of this Court; *Chapman v. Commissioner,* 14 T.C. 943 (1950), affd. 191 F.2d 816 (9th Cir. 1951)), or attorney's fees. *McQuiston v. Commissioner,* 78 T.C. 807 (1982), affd. without published opinion 711 F.2d 1064 (9th Cir. 1983); *Key Buick Co. v. Commissioner,* 68 T.C. 178 (1977), affd. 613 F.2d 1306 (5th Cir. 1980). See new sec. 7430(a)(2).

Decision will be entered for the petitioners.

Reviewed by the court.
Tannenwald, *Judge,* dissenting:

I disagree with the holding of the majority that the requirements of section 1031 were satisfied because the contribution of the Plaza Property by petitioner to U.S. Trust (the partnership) was simply "a continuation of the old investment unliquidated in modified form" (see pp. 770-771).

The rationale of continuity of investment rests on the false premise that "joint ownership of the property and partnership ownership of the property are merely formal differences and not substantial differences" [1] (see p. 773), and that, therefore, the "like-kind" requirement of the section has been met. I use the phrase "false premise" advisedly because the majority fails to analyze the differences between an interest of a fee owner or of a tenant in common and that of a general partner and, in particular, the impact of California law. Such an analysis would have required the conclusion that such interests were not of like kind.

Preliminarily, to determine whether properties are of like kind—

[we must] ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the [pg. 775]parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. [*Koch v. Commissioner,* 71 T.C. 54, 65 (1978).]

See also sec. 1.1031(a)-1(b), Income Tax Regs. Therefore, section 1031 requires that the rights of the taxpayer in, or his legal relationship to, the property held, [2] as well as the nature of the property itself, must be of like kind. [3] Consequently, respondent's concession that the underlying assets were of like kind is not determinative of the question whether petitioners' rights in those properties are of like kind as well.

Petitioners' first contention is that the exchange qualifies under section 1031 because, after the exchange, they held an interest in the Plaza Property as tenants in partnership, which is, they contend, a form of co-ownership under California law. [pg. 776]Respondent contends that partnerships, rather than individual partners, hold the underlying assets of California partnerships. I assume, for purposes of this opinion, that under California law general partners have some ownership interest in the underlying assets of their partnerships. See Cal. Corp. Code sec. 15025(l) (West 1977), which provides that "A partner is co-owner with his partners of specific partnership property holding as a tenant-in-partnership." Under such circumstances, I need not explore the troublesome question of whether the Internal Revenue Code adopts the entity theory as argued by respondent so as to create a partnership interest distinct from an interest of a general partner in the partnership assets. See *Casel v. Commissioner,* 79 T.C. 424, 430-433 (1982). My assumption, however, is merely the beginning, rather than the end, of my analysis because it is still necessary to determine the nature of the general partner's interest, which is a question of local law. See, *Aquilino v. United States,* 363 U.S. 509 (1960); *Commissioner v. Crichton,*

122 F.2d 181 (5th Cir. 1941), affg. 42 B.T.A. 490 (1940); *Oregon Lumber Co. v. Commissioner,* 20 T.C. 192 (1953); sec. 301.7701-1(c), Proced. & Admin. Regs.

Petitioners' second contention, which reflects the core of the controversy herein, is that, whether the situation is viewed as (1) an exchange of a fee interest in the Iowa Street Property for a tenancy-in-partnership interest in the Plaza Property pursuant to an integrated transaction, or (2) an exchange of a fee interest in the Iowa Street Property for a tenancy-in-common interest in the Plaza Property followed by a section 721 contribution of the tenancy-in-common interest to the partnership, like-kind exchanges which qualify under section 1031 are involved. Each scenario presents different questions. The first scenario turns on whether petitioners' fee interest in the Iowa Street Property and their tenancy-in-partnership interest in the Plaza Property were of like kind, it being conceded that petitioners "held" these interests for investment purposes. The second scenario assumes that petitioners' first position is not sustained and presents two questions: (1) Whether petitioners' fee interest in the Iowa Street Property and their tenancy-in-common interest in the Plaza Property were of like kind; (2) whether petitioners held their tenancy-in-common interest in the Plaza Property for investment purposes. I turn [pg. 777]first to the questions of whether petitioners' various rights in the properties were of like kind.
The owner of a fee simple interest has vested title to his property. Such title is inheritable and the holder thereof has full power to convey it.*Hagge v. Drew,* 27 Cal. 2d 368, 165 P.2d 461, 465 (1945).

A tenant in common owns an undivided interest in the property and is entitled to possession of the entire common property against all persons except his co-tenants. *Dimmick v. Dimmick,* 58 Cal. 2d 417, 374 P.2d 824, 24 Cal. Rptr. 856 (1962); *Wilkerson v. Thomas,* 121 Cal. App. 2d 479, 263 P.2d 678 (1953); *Swartzbaugh v. Sampson,* 11 Cal. App. 2d 451, 54 P.2d 73 (1936); *Wood v. Henley,* 88 Cal. App. 441, 263 P. 870 (1928). Title to his interest is vested in him and he may sell or encumber it without the knowledge, consent, or approval of the other co-owners. *Meyer v. Wall,* 270 Cal. App. 2d 24, 75 Cal. Rptr. 236 (1969). A tenant-in-common's interest is inheritable.*Wilkerson v. Thomas, supra.*
Unlike the forms of ownership discussed above, a partner has no legal title to property "owned" by him under section 15025(1), California Corporations Code, as a tenant in partnership; the interest of a partner in firm assets "is the share to which he is entitled after claims against the firm and accounts between the partners are settled; it is an equitable interest enforceable by an action for an accounting." *Comstock v. Fiorella,* 260 Cal. App. 2d 262, 67 Cal. Rptr. 104, 106 (1968). See also*Clarke v. Fiedler,* 44 Cal. App. 2d 838, 113 P.2d 275 (1941). Section 15025(2) of the California Corporations Code provides that—

The incidents of [the tenancy in partnership] are such that:

(a) A partner, subject to the provisions of this chapter and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.

(b) A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property.

(c) A partner's right in specific partnership property is not subject to attachment, or execution, except on a claim against the partnership. When partnership property is attached for a partnership debt the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the homestead or exemption laws.[pg. 778]

(d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.

(e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin, and is not community property.

On its face, section 15025(2) reflects a number of differences between a fee interest or an interest as a tenant in common on the one hand and an interest as a tenant in partnership on the other. For example, the former are assignable (*Hagge v. Drew, supra*; *Russell v. Lescalet,* 248 Cal. App. 2d 310, 56 Cal. Rptr. 399 (1967); see also*Tenhet v. Boswell,* 18 Cal. 3d 150, 554 P.2d 330, 133 Cal. Rptr. 10 (1976)), while the latter is not (sec. 15025(2)(b)); the former are subject to attachment (*Hagge v. Drew, supra*; *Caito v. United California Bank,* 20 Cal. 3d 694, 576 P.2d 466, 144 Cal. Rptr. 751 (1978); see also *People v. Nogarr,* 164 Cal. App. 2d 591, 330 P.2d 858 (1958); *Hagge v. Drew, supra*; *Wilkerson v. Thomas, supra*), while the latter is not (sec. 15025(2)); the former are subject to community property rules (*Estate of Murphy v. Murphy,* 15 Cal. 3d 907, 544 P.2d 956, 126 Cal. Rptr. 820 (1976); *Franklin v. Franklin,* 67 Cal. App. 2d 717, 155 P.2d 637, 641 (1945)), while the latter is not (sec. 15025(2)(e)). [4] Nothing in section 15025(1) undermines the impact of these differences.

In view of the foregoing, I am satisfied that, while under California law, petitioners' rights in respect of their fee interest in the Iowa Street Property and their rights in respect of their tenancy-in-common interest in the Plaza Property were of like kind, their rights in respect of those interests and their rights in respect of their tenancy-in-partnership interest were not of like kind. [5] Legal title to petitioners' interest in the[pg. 779] Plaza Property ceased to be in their names; by deed, petitioners "remise[d] and forever quitclaim[ed]" their interest in that property to the partnership. Consequently, the transformation of petitioners' outright ownership of an interest in real property into a partnership interest so changed their legal relationship to that property as to disqualify the exchange from section 1031(a) treatment. [6] Cf. *M.H.S. Co. v. Commissioner,* 575 F.2d 1177 (6th Cir. 1978), affg. a Memorandum Opinion of this Court;*Estate of Meyer v. Commissioner,* 503 F.2d 556 (9th Cir. 1974), affg. 58 T.C. 311 (1972); *Lakritz v. United States,* 418 F.Supp. 210, 213 (E.D. Wisc. 1976); *Gulfstream Land & Development v. Commissioner,* 71 T.C. 587 (1979); 4A R. Powell & P. Rohan, Powell on Real Property, sec. 614 (1982); 60 Am. Jur. 2d, Partnership, sec. 101 (1972); 2 American Law of Property, sec. 6.9 (1952); Jensen, "Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?" 16 Vand. L. Rev. 377 (1963); 2 W. McKee, W. Nelson & R. Whitmire, Fedeal Taxation of Partnerships and Partners, sec. 15.04(3)(b). But cf. 2 B. Bittker, Federal Taxation of Income, Estates and Gifts, sec. 44.3.4 (1981).

Since the underlying properties were of a like kind, petitioners can still prevail, despite the differences between rights in an interest as a tenant in common and rights in an interest as a tenant in partnership, if they "held" their tenancy-in-common interest in the Plaza Property for a section 1031(a) purpose. The majority resolves this issue in petitioners' favor by concluding that petitioners "held" the general partnership interest simply as a continuation of their holding as tenants in common of the 10-percent interest of the Plaza Property. In so concluding, the majority has subverted the express requirement of section 1031(a) that the *property received* in the exchange "*be held* either for productive use in trade or business or *for investment*." (Emphasis added.) Whatever the reach of that requirement may be where the taxpayer immediately exchanges the property received in the transaction for which the benefits of section 1031(a) is claimed in a tax-free transaction for an interest in the property of a like kind and [pg. 780]the rights of the taxpayer are substantially the same as those which it had in the property previously received, that requirement is clearly not satisfied where those rights are not substantially the same.[7]

The majority's analysis of the ancillary tax-free consequences of the exchange of the petitioners' tenancy-in-common interest for the general partnership interest is beside the point. These same consequences (no recapture of investment credit, nonapplication of sections 1245, 1250 and 453 and the carryover of basis and the tacking of holding periods) ensue in the case of a section 351 exchange where the property received in the exchange would be stock. See Rev. Rul. 75-292, 1975-2 C.B. 333; Comment, "Analysis of Revenue Ruling 75-292: A Proposal to Allow the Combined Use of Sections 1031 and 351 Without Destroying the Tax-Free Status of Either," 17 Wm. & Mary L. Rev. 599 (1976). Indeed, the majority's analysis in these respects substantially undermines its declination to decide whether a subsequent section 351 exchange would destroy the tax-free character of the original exchange under section 1031(a).[8][pg. 781]

Petitioners also argue that substance and intent should govern over the form of the transaction and that since petitioners intended the entire transaction to be tax free, this Court must find it so. Petitioners' argument on this basis is founded on the premise that they could have accomplished a completely tax-free transaction by first contributing the Iowa Street Property to the partnership in exchange for their partnership interest (sec. 721) and then having the partnership exchange that property for the Plaza Property (sec. 1031). In the first place, petitioners' premise may not be valid. The exchange by the partnership may not have satisfied the "held*for productive use in a trade or business or for investment* " (emphasis added) requirement of section 1031(a) with respect to the Iowa Street Property. See 2 A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation, sec. 101.07 (3d ed. 1983); 2 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, sec. 15.04(3)(b) (1977). See also note 7 *supra.* Secondly, the hard fact is that petitioners, for reasons of their own, structured the transaction as they did and they should not now be able to disavow that structuring because the tax consequences turned out to be different from what they had anticipated. See*Commissioner v. National Alfalfa Dehydrating & Milling Co.,* 417 U.S. 134, 149 (1974), affg. 57 T.C. 46 (1971);*Waltham Netoco Theatres, Inc. v. Commissioner,* 49 T.C. 399 (1968), affd. 401 F.2d 333 (1st Cir. 1968). Compare *United States v. Cumberland Public Service Co.,* 338 U.S. 451 (1950), with *Commissioner v. Court Holding Co.,* 324 U.S. 331 (1945). Compare also *Foxman v. Commissioner,* 41 T.C. 535 (1964), affd. 352 F.2d 466 (3d Cir. 1965).

Our opinion in *Wagensen v. Commissioner,* 74 T.C. 653 (1980), does not support petitioners' position. In *Wagensen,* we merely held that the taxpayer was entitled to nonrecognition under section 1031 even though he intended, when he acquired the property, *eventually* to transfer the property to his children. We distinguished Mr. Wagensen's eventual gift of the property from cases such as *Regals Realty Co. v. Commissioner,* [pg. 782] 127 F.2d 931 (2d Cir. 1942), affg. 43 B.T.A. 194 (1940), wherein the taxpayer had the *present* intent, when he received the like-kind property, to sell it. We applied this distinction in*Click v. Commissioner,* 78 T.C. 225 (1982), and held against the taxpayer under analogous circumstances. The instant case clearly falls within the ambit of *Click.*

I would hold for respondent.
Fay, Sterrett, and Cohen, *JJ.,* agree with this dissent.

Nims, *J.,* dissenting:

Since the Internal Revenue Code unquestionably proceeds upon the assumption that an interest in a partneship is itself a capital assets (see, for example, sec. 741), it seems quite aparent that a contribution of real property to a partnership and the receipt of a partnership interest in exchange therefor is not a like-kind exchange under sec. 1031, and I would so hold.

[1]

All section references are to the Internal Revenue Code of 1954 as amended, applicable to the taxable year 1977.

[2]

This section of the regulations does not reflect repeal of sec. 1002 of the Code and incorporation of the gist of sec. 1002 into sec. 1001 as sec. 1001(c) applicable to taxable years beginning after 1976. Pub. L. 94-455 (Tax Reform Act of 1976), 90 Stat. 1520. In T.D. 7665, 1980-1 C.B. 319, filed in the Office of the Federal Register on January 24, 1980, the Treasury removed sections of the regulations, including sec. 1.1002, Income Tax Regs. which no longer conformed to the Internal Revenue Code as amended. The Treasury Decision was effective Jan. 25, 1980, and by its terms intended no substantive changes in the regulations. Secs. 1.1001-1 and 1.1002-1 of the regulations are, therefore, applicable to the taxable year 1977 which is before the Court in this case.

[3]

Sec. 1250 does, however, override other nonrecognition provisions. Sec. 1.1250-1(c)(2), Income Tax Regs.

[4]

This assumes that U.S. Trust has not availed itself of the elective provisions regarding basis.

[5]

Furthermore, a partnership is not a taxpaying entity separate from its partners. Sec. 701. In noting this principle which distinguishes it from a corporation, however, we decline to decide whether property received in a sec. 1031(a) "like kind" exchange and immediately contributed to a

corporation qualifying for sec. 351 treatment is "held" for investment as required by sec. 1031(a). See Rev.Rul. 75-292, 1975-2 C.B. 333; but also see 17 Wm. & Mary L. Rev. 599 (1976).

1

I assume that the majority's use of the phrase "joint ownership" is colloquial and in fact refers to a tenancy-in-common interest which was petitioners' interest in the Plaza Property contributed to the partnership.

2

This requirement of sec. 1031(a) is generally unstated when the ownership interests involved are equivalent (e.g., fee interest in improved realty for fee interest in unimproved realty). However, sec. 1.1031(a)-1(c), Income Tax Regs., alludes to this requirement by stating that an exchange of a 30-year lease for a fee interest will qualify under sec. 1031. A leasehold of less than 30 years, however, is not the equivalent of a fee interest. See *Capri, Inc. v. Commissioner,* 65 T.C. 162, 181-182 (1975); *May Department Stores Co. v. Commissioner,* 16 T.C. 547, 556, (1951); *Standard Envelope Mfg. Co. v. Commissioner,* 15 T.C. 41, 48 (1950). The nature-of-ownership-interests requirement has also arisen in the oil and gas lease area. See, e.g.,*Crichton v. Commissioner,* 42 B.T.A. 490, 492-493 (1940), affd. 122 F.2d 181 (5th Cir. 1941); *Midfield Oil Co. v. Commissioner,* 39 B.T.A. 1154, 1157-1158 (1939). See also Rev.Rul. 68-331, 1968-1 C.B. 352. Similarly, respondent has conceded that a like-kind exchange occurs when the taxpayers exchange their undivided interests as tenants in common in three parcels of real estate for a 100-percent ownership interest in one parcel. Rev.Rul. 73-476, 1973-2 C.B. 300. See also, Rev.Rul. 55-351, 1955-1 C.B. 343; Rev. Rul. 57-154, 1957-1 C.B. 262.

3

This dual standard is reflected in*Estate of Meyer v. Commissioner,* 58 T.C. 311 (1972), affd. 503 F.2d 556 (9th Cir. 1974), wherein we held that an exchange of a general partnership interest for a general partnership interest satisfied the requirements of sec. 1031(a), while an exchange of a general partnership interest for a limited partnership interest did not so qualify even though in both instances the characteristics of the underlying partnership property were the same. By way of contrast, the primary focus of the more recent cases (*Pappas v. Commissioner,* 78 T.C. 1078 (1982); *Long v. Commissioner,* 77 T.C. 1045 (1981);*Gulfstream Land & Development v. Commissioner,* 71 T.C. 587 (1979)) was on the characteristics of the underlying partnership property. As a consequence of the presence in this case of like-kind real estate, there is no occasion to explore the nuances of the varying language in *Gulfstream Land & Development v. Commissioner, supra,* and *Pappas v. Commissioner, supra,* where we stated that, in an exchange of general partnership interests, we look to the underlying assets "only to determine whether that bona fide exchange of partnership interests violates clear congressional intent to exclude exchanges of stock in trade from qualification under section 1031(a)," *Gulfstream Land & Development v. Commissioner, supra* at 595-596, and in *Long v. Commissioner, supra,* where we stated that sec. 1031 "require[s] that the underlying assets of each partnership be of like kind[.]" *Long v. Commissioner, supra* at 1072. See Brier, "Like-Kind Exchanges of Partnership Interests: A Policy Oriented Approach." 38 Tax L. Rev. 389, 405 (1983).

4

Dower and curtesy have been abolished in California. See Cal. Civ. Code sec. 5129 (West 1983).

5

See Wright, "California Partnership Law and the Uniform Partnership Act," 9 Cal. L. Rev. 116 (1921), published prior to California's adoption of the Uniform Partnership Act, which contains an exhaustive analysis of the differences between a tenancy in common and a tenancy in partnership in light of the effect of the changes made by the UPA on a partner's ownership rights in the partnership's underlying property.

6

In view of this conclusion, it is unnecessary for me to decide whether the property exchanged for the partnership interest was the Iowa Street Property or the Plaza Property. In either case, the nature of petitioners' rights was substantially altered.

7

With one exception, the legislative history of sec. 1031(a) does not specifically address the application of the "held" requirement to property received in the exchange. Nevertheless, it is clear that Congress was concerned that such requirement not be broadly applied. See H. Rept. 486, 67th Cong., 1st Sess. 10 (1921), 1939-1 C.B. (Part 2) 168, 175-176; S. Rept. 275, 67th Cong., 1st Sess. 11 (1921), 1939-1 C.B. (Part 2) 181, 188-189; Hearings on H.R. 8245 Before the Senate Committee on Finance, 67th Cong., 1st Sess. 201 (1921), 1939-1 C.B. (Part 2) 206, 209; S. Rept. 1113, 67th Cong., 1st Sess. 1-2 (1923), 1939-1 C.B. (Part 2) 845, 846; S. Rept. 398, 68th Cong., 1st Sess. 14 (1924), 1939-1 C.B. (Part 2) 266, 276. See also 65 Cong. Rec. 2856 (1923), where Congressman Hawley stated, in describing how the like-kind nonrecognition provision worked, that the taxpayer "then *** must hold the land he receives in exchange as an investment, *at least for a time.*" (Emphasis added.)

There may be situations in which a taxpayer exchanges his interest in property for an interest as a tenant in partnership (where the property involved represents the bulk of the holdings of the partnership) and the latter interest is so substantial that it may well be concluded that no significant change in the taxpayer's interest occurred. See Brier,*supra* note 3, at 406. Compare Rev. Rul. 75-292, 1975-2 C.B. 333. A 10-percent interest as a tenant in partnership simply does not fall within such an exceptional category. On the other hand, a transaction which might fall within this exceptional category, such as an interest in a tenancy in partnership as a general partner acquired and then exchanged for another such interest in an integrated transaction such as that involved herein (the underlying properties being of a like kind), might still be subject to the "held" requirement of sec. 1031.

8

A similar problem arises in a situation where an individual who is the sole shareholder of a corporation holding real property for investment desires to have that property exchanged for other like-kind property which he then intends to hold for investment in his individual capacity. Whether the shareholder, pursuant to an integrated transaction, liquidates the corporation first and then makes the exchange or has the corporation make the exchange first and then liquidates, there has been a transmutation of petitioner's investment from stock to real estate. The majority rationale would appear to lead to the conclusion that the "held" requirement of sec. 1031(a) has been met with the result that the preliquidation exchange in one case or the postliquidation exchange in the other would be tax free.

PRIVATE LETTER RULING 200521002

Date:

February 24, 2005
TY:

LEGEND:

Trust =
Decedent =
X =
Year A =
X Beneficiaries =
Date A =
Date B =
Date C =
Date D =
Date E =
Date F =
Date G =
State A =
State B =
X percent =
Y percent =
Z percent =
LLC =
Relinquished Property =
$Y =
Buyer
QI =

Dear [Redacted Text]:

This is in response to your request for a private letter ruling dated June 30, 2004, submitted by your authorized representatives as to the application of § 1031(a) of the Internal Revenue Code to the proposed transaction. Specifically, you have requested a ruling that a testamentary trust may hold replacement property received in this like-kind exchange of real property "for productive use in a trade or business or for investment" within the meaning of § 1031(a) notwithstanding that the trust must terminate by its own terms and thus distribute all of its properties, when the like-kind exchange is independent of the impending termination.

The following facts are pertinent to your ruling request. The Taxpayer is a private testamentary trust ("Trust") established by Decedent upon his death in Year A to administer his assets. Decedent's will provided for the establishment of the Trust in order to provide an ongoing source of safe and certain income to its beneficiaries, which included Decedent's wife and daughters. Under the terms of Decedent's will, the Trust will terminate at midnight on Date A, which is twenty years after the death of Decedent's last surviving child. Because the Trust is due to terminate, the trustees of the Trust ("Trustees") formulated a detailed Plan of Termination, which outlines a plan and mechanism for the distribution of the Trust's assets to its remainder beneficiaries upon its termination. Trust presently has X beneficiaries. Trust is required to distribute all of its income currently, may not make any other distributions to charitable or other beneficiaries, and is taxed as a "simple trust" under § 651.

Originally, the assets of the Trust consisted mainly of real estate holdings in State A. The submission provides that, in order to diversify the Trust's real estate holdings, increase investment returns, and generate income, the Trustees received approval from the State A probate court many years ago to conduct exchanges of real estate. The Trustees have engaged in many such exchanges, which have been structured to qualify for nonrecognition treatment under § 1031. Trust intends to continue to enhance its investment operations by strategically exchanging certain assets in its portfolio. As a result, the assets in the Trust now include real estate holdings in State A and diversified industrial, office, and retail properties located in other states. Your submission states that all of the Trust's directly-owned properties are held for investment purposes. Recently, the value of the Trust's assets approximated $X.

Under the Plan of Termination, approximately X percent of the Trust will be distributed on termination in cash to certain remainder beneficiaries. Y percent of the Trust will be distributed on termination through an in-kind distribution of one or more Trust properties to one expected remainder beneficiary. The remaining corpus (approximately Z percent) of the Trust's net asset value will be contributed by the Trustees prior to termination to LLC, a to-be-formed State B limited liability company, with the Trust as the single member holding all of the shares in the LLC. All of the shares in LLC will then be distributed upon termination by the Trust among the remainder beneficiaries (to the extent their remainder interest is not otherwise satisfied with cash or in-kind property). LLC is intended to continue the Trust's real estate investment operations in a manner consistent with past practices. It is expected that much of the current managerial and operational structure will remain in place after the Trust terminates. The submission also provides that as a result of the large number of real estate parcels and the large number of beneficiaries, the Plan of Termination can only be effected by contributing the assets to an entity prior to and in conjunction with the Trust's terminating distributions. The Trustees submitted the Plan of Termination to the State A probate court, which approved it on Date B.

The Trustees have determined that it would be in the best interests of the Trust to dispose of the Relinquished Property in an exchange that would qualify for nonrecognition under § 1031. The Relinquished Property includes the facilities and underlying land, together with all rights and appurtenances pertaining to the facilities and land.

The Trust entered into a disposition agreement dated Date C with Buyer to dispose of the Relinquished Property for $Y in cash. The Trust transferred Relinquished Property to Buyer on Date D. One day earlier, the Trust assigned its interest in the disposition agreement to QI, a qualified intermediary for purposes of the safe harbor provided in § 1.1031(k)-1(g)(4) of the Income Tax Regulations, pursuant to an "Assignment and Assumption Agreement." The Trust also entered into "Exchange Agreement" with QI in order to facilitate the disposition of the Relinquished Property and the identification and acquisition of suitable replacement properties in accordance with the safe harbor deferred exchange regulations under § 1031.

According to the submission, once identified and acquired in completion of the exchange, the Trustees intend to hold the replacement property solely to generate additional rental income and have no plans to develop or construct any improvements on the property, or to sell the replacement property or any portion of it at any time. Pursuant to the Plan of Termination, the Trustees will convey the replacement property to LLC sometime on or before Date F and will distribute all of the Trust's interests in LLC to certain beneficiaries on Date G (or as soon thereafter as possible). In addition, the Trust makes the following representations:

> (1) The Relinquished Property now and at all times during the Trust's ownership thereof, has been held by the Trust for investment purposes; (2) The disposition of the Relinquished Property and the acquisition of the replacement property will be accomplished in a manner that in all respects (aside from the future conveyance to LLC and the distribution of LLC to the beneficiaries of Trust upon termination) qualifies the transaction as a tax-free exchange within the meaning of §1031 and the regulations thereunder;
>
> (3) The replacement property will be of "like kind" to the Relinquished Property for purposes of §1031 and will be held by the Trust (and then LLC) for investment purposes throughout the Trust's existence; and (4) LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A at which time it will be deemed to become a partnership for federal income tax purposes as a result of the Trust's terminating distribution of the membership interests of LLC to multiple beneficiaries.

Law and analysis

As stated above, you have requested a ruling that the Trust may hold replacement property received in this like-kind exchange of real property "for productive use in a trade or business or for investment" within the meaning of § 1031(a) notwithstanding that the Trust must terminate by its own terms and distribute all of its properties, when the like-kind exchange is independent of the impending termination.

Section 1031(a)(1) provides 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 the property is exchanged solely for property of a like kind which is to be held either for productive use in a trade or business or for investment. Under § 1.1031(a)-1(b) relating to the meaning of the term "like kind," real property is generally considered to be of like kind to all other real property, whether or not any of the real property involved is improved.

In Rev. Rul. 75-292,1975-2 C.B. 333, an individual taxpayer in a prearranged transaction transferred land and buildings used in the taxpayer's trade or business to an unrelated corporation in exchange for land and an office building owned by the corporation and used in its trade or business. Immediately thereafter, the individual taxpayer transferred the land and office building to the individual's newly created corporation in exchange for the stock of the same corporation in a transaction that qualified for nonrecognition of gain under § 351. The revenue ruling concluded that the individual taxpayer did not exchange the real estate for other real estate to be held either for productive use in a trade or business or for investment by that taxpayer. Instead, the ruling concluded that the replacement property was acquired by the individual taxpayer for the purpose of transferring it to the new corporation in exchange for stock pursuant to § 351. As a result, the ruling held that, as to that individual taxpayer, the exchange did not qualify for nonrecognition under § 1031.

In Rev. Rul. 77-337, 1977-2 C.B. 305, an individual taxpayer owned all of the stock of a corporation. In a prearranged plan, the individual taxpayer liquidated the corporation and transferred the corporation's sole asset, a shopping center, to a third party in exchange for like-kind property. Rev. Rul. 77-337 noted that under Rev. Rul. 75-292, a newly created corporation's eventual productive use of property in its trade or business is not attributable to its sole shareholder. Rev. Rul. 77-337 thus concluded that the transaction between the individual taxpayer and the third party was a prearranged plan whereby the corporation was liquidated to facilitate the further exchange between the individual taxpayer and the third party of their respective properties. Consequently, the individual taxpayer did not hold the shopping center for use in a trade or business or for investment because the corporation's previous trade or business use could not be attributed to its sole shareholder. Therefore, the exchange did not qualify for nonrecognition of gain or loss under § 1031.

Wagensen v. Commissioner, 74 T.C. 653 (1980), pertains in part to an exchange of real property, a ranch, for like-kind property followed by a gift of the newly acquired ranch property to the taxpayer's children. The court found that the exchange qualified under § 1031. The ranch properties in question were held for use in a trade or business or for investment by taxpayer both before and after the exchange.

Under § 301.7701-3(b)(1)(ii), a domestic eligible entity is generally (with exceptions noted) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-2(c)(2) provides that, in general, a business entity that has a single owner and is not a corporation (as defined in § 301.7701-2(b)) is disregarded as an entity separate from its owner for federal tax purposes.

Your submission expresses two concerns regarding the above exchange. Your first concern is that the proposed transfer of the replacement property to LLC would violate the holding requirement of § 1031(a) (i.e., that the replacement property must be held by the taxpayer for productive use in a

trade or business or for investment) as applied in Rev. Rul. 75-292 and Rev. Rul. 77-337. Your second concern is that, as a result of the Trust's terminating distribution of membership interests in LLC to multiple beneficiaries, which will then result in a *de facto* partnership between the beneficiaries for federal income tax purposes, the holding requirement of § 1031(a) as applied in the revenue rulings would be violated with respect to the replacement property.

With respect to your first concern, you represent that the replacement property will be held by the Trust (and LLC) for investment pur poses throughout the Trust's existence. You also represent that LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A. Therefore, LLC will be disregarded as an entity separate from the Trust, its sole owner. Consequently, the transfer by the Trust of the replacement property to LLC will also be disregarded, and the Trust will be considered the direct owner of the replacement property for federal income tax purposes. Because the Trust represents that it intends to hold the replacement property for investment purposes, the transfer by the Trust of the replacement property to LLC will not violate the holding requirement of § 1031(a). [1]

With respect to your second concern, the Trust represents that it will hold the replacement property for investment purposes until the Trust terminates by its own terms on Date A. Because the Trust is a testamentary trust, the termination date was fixed by Decedent and cannot be modified or changed. As a result, the Trust is not acquiring the replacement property in order to dispose of the property pursuant to a prearranged plan. The Plan of Termination has been approved by the State A probate court and will take effect without regard to whether this exchange of properties is consummated. Consequently, the like-kind exchange in this case is wholly independent from the distribution of the properties under the Plan of Termination. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77- 337.

Therefore, based on the facts and representations presented above, we rule that the Trust's termination and distribution of its assets to the beneficiaries will not preclude the replacement property received by the Trust in this exchange from being considered property held either for productive use in a trade or business or investment, within the meaning of § 1031, because this like-kind exchange is independent of the impending termination.

No determination is made by this ruling letter as to whether the described transaction otherwise qualifies for deferral of gain realized under § 1031. We express no opinion, except as specifically ruled above, as to the federal income tax treatment of the transaction under any other provisions of the Code and regulations that may be applicable or under any other general principles of federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction(s) that are not specifically covered by the above ruling.

You should attach a copy of this ruling to your tax return for the taxable year in which the transaction covered by this ruling is consummated. We are enclosing a copy for that purpose.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. This ruling is directed only to the taxpayers who requested it.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

By: Roy A. Hirschhorn
Assistant Branch Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)

OIL, GAS AND MINERAL RIGHTS (ARTICLE)

Investors who desire tax deferral on the sale or exchange of oil and gas interests may have the opportunity to reap the advantages of an exchange. As in any exchange, it is important to consult with tax and legal advisors regarding applicable state laws and the specifics of each transaction whenever oil, gas or mineral interests are involved.

Investors will want to analyze exactly the nature of the oil or gas interest to evaluate whether or not it might qualify for tax deferred treatment under IRC §1031. A production payment is usually considered personal property because it is treated as an assignment of income and, therefore, is not like-kind to a real property interest. [Comm. V. P.G. Lake, Inc. (1958)] However, a royalty is generally considered "like-kind" real property and can be exchanged for any other real property. [Anderson V. Helvering, (1940); Rev. Rul. 72-117 (1972)].

DURATION IS IMPORTANT

The primary distinction between these two types of interests is the duration of the respective interest. An overriding royalty interest continues until the oil or gas deposit is exhausted. On the other hand, a production payment usually terminates when a specified quantity of oil or gas has been produced or a stated amount of proceeds have been received.

MINERAL RIGHT ISSUES

Minerals transferred with a fee interest can also be considered part of the real estate and not a separate asset or inventory to the property owner. [Butler Consol. Coal Co. v. Comm. (1946)]. Generally a working interest or royalty interest can be exchanged for another working or royalty interest or other real property. However, the IRS may disallow an exchange if the investor sells a working interest and retains royalty interests or surface rights.

The following exchanges did qualify for tax deferral:

- Overriding royalty interest in oil, gas and mineral rights for an undivided one-half of the fee in a parcel of improved real property. [Crichton, Kate (1940)]
- An interest in a producing oil lease extending until the exhaustion of the deposit for a fee interest in an improved ranch. [Rev. Rul. 68-331 (1968)]
- Perpetual water rights for a fee interest in land, when local law treats water rights as real property rights and the water right is in perpetuity as compared to a specific amount of water. [Rev. Rul. 55-749 (1955)]

The following did not qualify for tax deferral:

- Limited oil payment right for an overriding oil and gas royalty where the oil payment was a limited interest and the overriding royalty was to continue as long as gas or oil might be produced. [Midfield Oil. Co. (1939)]
- Leasehold measured in terms of a fixed percentage of all oil that might be produced from leasehold measured in terms of a fixed number of barrels of oil. [Bandini Petroleum Co. (1951)].

Carved out oil payment rights for a fee interest in a ranch, even though local law treated them all as interests in real property. [Fleming, William (1955)].

ANDERSON V. HELVERING, CITE AS 24 AFTR 967 (60 S.CT. 952)

Case Information:
Code Sec(s):
Court Name: U.S. Supreme Court.
Docket No.: Nos. 682, 683.
Date Argued: 04/02/1940
Date Decided: 05/20/1940
Disposition:
Cites: 24 AFTR 967, 310 US 404, 60 S Ct 952, 84 L Ed 1277, 40-1 USTC P 9479.

OPINION

Mr. Charles H. Garnett, of Oklahoma City, for petitioners.

Mr. J. Louis Monarch, Sp. Asst. to Atty. Gen., for respondent.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit. [pg. 968]

Petitions by J. Steve Anderson and L. H. Prichard to review decisions of the United States Board of Tax Appeals affirming determinations of Guy T. Helvering, Commissioner of Internal Revenue as to alleged deficiencies in income tax payments. To review a judgment of the Circuit Court of Appeals, 107 F.2d 459, affirming the decisions, the petitioners bring certiorari.

Affirmed.

Judge: Mr. Justice MURPHY delivered the opinion of the Court.

Oklahoma City Company in 1931 owned certain royalty interests, fee interests, and deferred oil payments in properties in Oklahoma. During that year it entered into a written contract with petitioner Prichard providing for the conveyance to him of these interests for the agreed consideration of one hundred sixty thousand dollars, payable fifty thousand in cash and one hundred ten thousand from one-half of the proceeds received by him which might be derived from oil and gas produced from the properties and from the sale of fee title to any or all of the land conveyed. Interest at the rate of 6% per annum was to be paid from the proceeds of production and of sales upon the unpaid balance. Oklahoma Company was to have in addition a first lien and claim against "that one half of all oil and gas production and fee interest *** from which the $110,000 is payable", the lien and claim "not in any way [to] affect the one-half interest in all oil and gas production and fee interest or the revenue therefrom which *** [it] is to have and receive under this agreement." The proceeds derived from the oil and gas produced and from sales of the fee interests were to be paid directly to Pritchard who was to deposit one-half of them at a designated bank, at intervals of 90 days, to the credit of Oklahoma Company. The agreement recited that Oklahoma Company desired "to sell all of its right, title and interest of whatsoever nature" in the described properties, and provided that a copy of the agreement and a release be placed in escrow for delivery to Prichard upon payment in full of the one hundred ten thousand dollars and interest. Immediately upon the execution of the contract the properties were conveyed to Prichard without reservation. 1 In entering into the agreement Prichard acted not only for himself but also for petitioner Anderson, each of them having a 45% interest. 2

The gross proceeds derived from the production and sale of oil from the properties 3 during 1932 amounted to some eighty-one thousand dollars. Prichard, upon receiving this sum, distributed one-half to Oklahoma Company pursuant to the contract. The question for decision is whether the proceeds thus paid over to Oklahoma Company [pg. 969] should be included in the gross income of petitioners for the tax year 1932. 4 The ruling of the Board of Tax Appeals against petitioners was affirmed by the Circuit Court of Appeals. 10 Cir., 107 F.2d 459. Because of an asserted conflict with the applicable decisions of this Court, we granted certiorari. 309 U.S. 645, 60 S.Ct. 609, 84 L.Ed. 998. March 4, 1940.

[1] It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest. Helvering v. Bankline Oil Co., 303 U.S. 362, 367, 58 S.Ct. 616, 618, 82 L.Ed. 897; Helvering v. O'Donnell, 303 U.S. 370, 58 S.Ct. 619, 82 L.Ed. 903; Helvering v. Elbe Oil Co., 303 U.S. 372, 58 S.Ct. 621, 82 L.Ed. 904; Thomas v. Perkins, 301 U.S. 655, 661, 663, 57 S.Ct. 911, 913, 914, 81 L.Ed. 1324; Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312, 321, 55 S.Ct. 174, 178, 79 L.Ed. 383; Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489. Compare Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788. No. 383, October Term, 1939.

[2] Oil and gas reserves like other minerals in place, are recognized as wasting assets. The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. Burnet v. Harmel, 287 U.S. 103, 106, 107, 53 S.Ct. 74, 75, 77 L.Ed. 199; Bankers' Coal Co. v. Burnet, 287 U.S. 308, 53 S.Ct. 150, 77 L.Ed. 325; United States v. Biwabik Mining Co., 247 U.S. 116, 38 S.Ct. 462, 62 L.Ed. 1017; Von Baumbach v. Sargent Land Co., 242 U.S. 503, 521, 522, 37 S.Ct. 201, 206, 61 L.Ed. 460; Stratton's Independence v. Howbert, 231 U.S. 399, 414, 34 S.Ct. 136, 139, 58 L.Ed. 285. The depletion effected by production is likened to the depreciation of machinery or the using up of raw materials in manufacturing. United States v. Ludey, 274 U.S. 295, 302, 303, 47 S.Ct. 608, 610, 611, 71 L.Ed. 1054; Lynch v. Alworth-Stephens Co., 267 U.S. 364, 370, 45 S.Ct. 274, 275, 69 L.Ed. 660. Compare Von Baumbach v. Sargent Land Co., supra, 242 U.S. at pages 524, 525, 37 S.Ct. 201, 208, 209, 61 L.Ed. 460. The deduction is therefore permitted as an act of grace and is intended as compensation for the capital assets consumed in the production of income through the severance of the minerals. Helvering v. Bankline Oil Co., 303 U.S. 362, 366-367, 58 S.Ct. 616, 617, 618, 82 L.Ed. 897. The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance. Helvering v. Twin Bell Oil

Syndicate, 293 U.S. 312, 321, 55 S.Ct. 174, 178, 79 L.Ed. 383; United States v. Dakota-Montana Oil Co., 288 U.S. 459, 467, 53 S.Ct. 435, 438, 77 L.Ed. 893.

[3-5] The sole owner and operator of oil properties clearly has a capital investment in the oil in place, if anyone has, and so is taxable on the gross proceeds of production and is granted a deduction from gross income as compensation for the consumption of his capital. See Burnet v. Harmel, supra, 287 U.S. at pages 107, 108, 53 S.Ct. 75, 76, 77 L.Ed. 199; Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788, No. 383, October Term, 1939. By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance. "The words 'gross income from the property,' as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves." Helvering v. Elbe Oil Land Co., 303 U.S. 372, 375, 376, 58 S.Ct. 621, 622, 82 L.Ed. 904.

[6] Other situations, falling between the two mentioned, have been put on one [pg. 970] side or the other as the cases arose. The holder of a royalty interest—that is, a right to receive a specified percentage of all oil and gas produced during the term of the lease—is deemed to have "an economic interest" in the oil in place which is depleted by severance. Palmer v. Bender, 287 U.S. 551, 557, 53 S.Ct. 225, 226, 77 L.Ed. 489; Murphy Oil Co. v. Burnet, 287 U.S. 299, 53 S.Ct. 161, 77 L.Ed. 318; Burnet v. Harmel, 287 U.S. 103, 53 S.Ct. 74, 77 L.Ed. 199. See Lynch v. Alworth-Stephens Co., 267 U.S. 364, 45 S.Ct. 274, 69 L.Ed. 660. Cash bonus payments, when included in a royalty lease, are regarded as advance royalties and are given the same tax consequences. Burnet v. Harmel, 287 U.S. 103, 53 S.Ct. 74, 77 L.Ed. 199; Murphy Oil Co. v. Burnet 287 U.S. 299, 53 S.Ct. 161, 77 L.Ed. 318; Bankers' Pocahontas Coal Co. v. Burnet, 287 U.S. 308, 53 S.Ct. 150, 77 L.Ed. 325. Compare Helvering v. Elbe Oil Land Co., 303 U.S. 372, 375, 58 S.Ct. 621, 622, 82 L.Ed. 904. A share in the net profits derived from development and operation, on the contrary, does not entitle the holder of such interest to a depletion allowance even though continued production is essential to the realization of such profits. Helvering v. O'Donnell, 303 U.S. 370, 58 S.Ct. 619, 82 L.Ed. 903; Helvering v. Elbe Oil Co., 303 U.S. 372, 58 S.Ct. 621, 82 L.Ed. 904. Similarly, the holder of a favorable contract to purchase wet gas at the mouth of the well is denied a depletion allowance on the difference between the contract price and the fair market value. Helvering v. Bankline Oil Co., 303 U.S. 362, 58 S.Ct. 616, 82 L.Ed. 897. Such an interest has been characterized by us as a "mere economic advantage derived from production, through a contractual relation to the owner." Helvering v. Bankline Oil Co., supra, 303 U.S. at page 367, 58 S.Ct. at page 618, 82 L.Ed. 897.

Thomas v. Perkins, 301 U.S. 655, 57 S.Ct. 911, 81 L.Ed. 1324, relied upon by petitioners, presented the issue whether the right to oil payments—that is, the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced—should be treated for tax purposes like the right to oil royalties or like the right to cash payments upon a sale. In that case, the assignment of lease provided for payments in oil only without the reservation of a royalty interest. The question was whether the assignees' gross income should include moneys paid to the assignors by purchasers of the oil. We stated (301 U.S. page 659, 57 S.Ct. page 912, 81 L.Ed. 1324): "The granting clause in the assignment would be sufficient, if standing alone, to transfer all the oil to the assignee. It does not specifically except or exclude any part of the oil. But it is qualified by other parts of the instrument. The provisions for payment to assignors in oil only, the absence of any obligation of the assignee to pay in oil or in money, and the failure of assignors to take any security by way of lien or otherwise unmistakably show that they intended to withhold from the operation of the grant one-fourth of the oil to be produced and saved up to an amount sufficient when sold to yield $395,000." Under these circumstances, the moneys received by the assignors from the sale of the oil were deemed not to be income to the assignees. See also Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489.

The holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place. The value of the right, even though dependent upon the extent of the oil reserves, is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments. Yet it does depend upon the production of oil, ordinarily can be realized upon only over a period of years, and permits of a simple and convenient allocation between lessor and lessee of both the gross income derived from production and the allowance for depletion. Compare Burnet v. Harmel, 287 U.S. 103, 106, 107, 53 S.Ct. 74, 75, 77 L.Ed. 199. Accordingly, this Court in Thomas v. Perkins decided that the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties. The decision did not turn upon the particular instrument involved, or upon the formalities [pg. 971] of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type. See Palmer v. Bender, 287 U.S. 551, 555-557, 53 S.Ct. 225, 226, 77 L.Ed. 489; Burnet v. Harmel, 287 U.S. 103, 111, 53 S.Ct. 74, 77, 77 L.Ed. 199.

The Government maintains that the present case is distinguishable from Thomas v. Perkins for the reason that the basis for decision there was that ownership of sufficient oil to make the payments had not been conveyed to the assignee but remained in the assignor. It asserts that the terms of the contract and the instruments of conveyance here negative any intention on the part of the parties to withhold from the operation of the grant an amount of oil equal to the oil payments. The following factors, among others, are relied upon as supporting this contention: (1) the contract contains no qualifying language reserving from the grant any interest in the oil and gas in place; (2) the deferred payments of one hundred ten thousand dollars were payable in cash and not directly in oil; (3) the deferred payments drew interest until paid; (4) Oklahoma Company had a first lien and claim against one-half of the oil and gas production and fee interest; (5) petitioner Prichard had the right to sell the fee interest covered by the contract and discharge the deferred payments out of the proceeds of such sale rather than out of the proceeds of the oil and gas production.

Several of the distinctions urged upon us by the Government are without substance. The economic consequences of the transaction are not materially affected by the circumstance that the provision for oil payments is not phrased in terms of a reservation from the conveyance to Oklahoma Company of an interest in the oil and gas in place. And the fact that the payments to Oklahoma Company are in cash rather than directly in oil is of no moment in determining the issues presented for decision. Compare, however, General Utilities Co. v. Helvering, 296 U.S. 200, 56 S. Ct. 185, 80 L.Ed. 154. Similarly, the retention of a lien, if it were construed as a lien only upon the oil and gas production, and nothing more, 5 would not make Oklahoma Company any the less dependent upon such production for payment of the amounts reserved.

The reservation of an interest in the fee, in addition to the interest in the oil production, however, materially affects the transaction. Oklahoma Company is not dependent entirely upon the production of oil for the deferred payments; they may be derived from sales of the fee title to the land conveyed. It is clear that payments derived from such sales would not be subject to an allowance for depletion of the oil reserves, for no oil would thereby have been severed from the ground; an allowance for depletion upon the proceeds of such a sale would result, contrary to the purpose of Congress, in a double deduction—first, to Oklahoma Company; second, to the vendee-owner upon the production of oil. Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312, 321, 55 S.Ct. 174, 178, 79 L.Ed. 383. We are of opinion that the reservation of this additional type of security for the deferred payments serves to distinguish this case from Thomas v. Perkins. It is similar to the reservation in a lease of oil payment rights together with a personal guarantee by the lessee that such payments shall at all events equal the specified sum. In either case, it is true, some of the payments received may come directly out of the oil produced. But our decision in Thomas v. Perkins does not require that payments reserved to the transferor of oil properties shall for tax purposes be treated distributively, and not as a whole, depending upon the source from which each dollar is derived. An extension of that decision to cover the case at bar would create additional, and in our opinion unnecessary, difficulties to the allocation for income tax purposes of such payments and of the allowance for depletion between transferor and transferee. In the interests of a workable rule, Thomas v. Perkins must not be extended beyond the situation in which, as a matter of substance, without regard to formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas. The deferred payments reserved by Oklahoma Company, [pg. 972] accordingly, must be treated as payments received upon a sale to petitioners, not as income derived from the consumption of its capital investment in the reserves through severance of oil and gas.

[7] Petitioners, as purchasers and owners of the properties, are therefore taxable upon the gross proceeds derived from the oil production, notwithstanding the arrangement to pay over such proceeds to Oklahoma Company. See Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788, No. 383, October Term, 1939; Reinecke v. Smith, 289 U.S. 172, 177, 53 S.Ct. 570, 572, 77 L.Ed. 1109; Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918.

Affirmed.

1
Petitioners state that "the instruments of transfer of those properties were absolute and unqualified assignments and conveyances" and that there was "no reservation of any sort of interest, much less any legal interest, specified in those assignments and conveyances".

2
The remaining 10% interest was acquired for one Olsen, whose case was consolidated with those of Pritchard and Anderson, and disposed of in the same opinion below, but who has not sought review here.

3
The record does not indicate what portion of the gross proceeds was derived from the production and sale of oil and gas and what portion, if any, was derived from sales of fees and from royalties on leases. The Commissioner in determining deficiencies against petitioners, however, added $11,276.39 to the gross income of each with the explanation that this amount represented "In-oil payments received in connection with the Patterson [Oklahoma Company] Deal" not reported by petitioners. Respondent, in view of this explanation by the Commissioner and the omission from the record of any disclosure of the method of computing the $11,276.39 addition to gross income, accepts petitioners' statement that "the only income from the properties here in dispute is from oil production".

4
Revenue Act of 1932, c. 209, 47 Stat. 169, 26 U.S.C.A. Int.Rev.Acts, page 482 et seq.

5
The lien here appears to cover both the oil and gas production and the fee interest from which the deferred payments were to be derived.

BUTLER CONSOLIDATED COAL COMPANY V. COMMISSIONER, 6 TC 183

Case Information: [pg. 183]

Code Sec(s): 117

Docket: Docket No. 5344.

Date Issued: 02/06/1946

Counsel

W. A. Séifert, Esq., Sidney B. Gambill, Esq., and *A. G. Wallerstedt, C. P. A.*, for the petitioner.

Richard L. Shook, Esq., for the respondent.

This proceeding is for the redetermination of a deficiency in income tax for 1941 in the amount of $57,328.95. The questions in issue are:

(1) The amount of the loss sustained by the petitioner in 1941 from the sale of its "Erico" property.

(2) The amount of the carry-over loss from 1939 and 1940 which the petitioner is entitled to deduct from the gross income of 1941. The determination of the amount depends upon whether a loss sustained by the petitioner in 1940 from the foreclosure of a mortgage upon its "Argentine" property was an ordinary loss or a long term capital loss, and also whether interest which accrued upon its outstanding indebtedness in those two years is deductible from gross income.

FINDINGS OF FACT.

The petitioner is a corporation, organized under the laws of the Commonwealth of Pennsylvania, with its principal office at Butler. The company was in receivership for about 10 years prior to August 1, 1941. Its returns for 1939 and 1940, as well as for several prior years, were filed by the receiver. All of its tax returns were filed with the collector of internal revenue for the twenty-third district of Pennsylvania, at Pittsburgh.

The petitioner has always kept its books of account and filed its tax returns on the accrual basis and for the calendar year.

Petitioner has for many years been engaged in the business of mining coal and the sale of the mined coal. During the periods involved herein petitioner operated several mining properties about 14 miles east of Butler, Pennsylvania, and a large completely mechanized electrified plant at Wildwood, about 14 miles north of Pittsburgh.

In 1923 petitioner purchased coal in place, surface lands, buildings, and equipment, known as the "Argentine" property, at a cost in excess of $300,000, of which $197,925 represented the cost of the coal in place. A part of the consideration for the property was satisfied by the assumption of a first mortgage on the property in the amount of $200,000. Prior to October 25, 1940, the principal amount of this assumed mortgage had been reduced by payments and on October 25, 1940, the unpaid principal amount of the mortgage was $100,000. On the same date the mortgage was foreclosed by the mortgagee and the property was sold at public auction. At the time of the foreclosure there was an oral understanding between the petitioner and the mortgagee[pg. 185] that, if petitioner would pay the delinquent property taxes accumulated on the property to the date of the sale, the mortgagee would not sue for a deficiency judgment, and no such suit was thereafter brought. In addition, the mortgagee canceled $250 of the principal sum owed by the petitioner on the original purchase price. On December 5, 1940, the Argentine property was deeded to the purchaser by the sheriff of Butler County, Pennsylvania.

Mining operations on the Argentine property were discontinued in 1931. The mining equipment was removed from the mine and most of it was stored in buildings on or near the property. Some of it was later sold. The mine was allowed to fill with water.

The depletion allowed and allowable with respect to the coal in place on the Argentine property prior to December 31, 1931 (after which date no coal was mined from the property), was $21,853.29.

In its income tax return for 1940 the petitioner claimed the deduction from gross income of the full amount of its investment in the Argentine property. In computing the net loss of petitioner for 1940 the respondent held that the petitioner sustained a loss in 1931 of its investment in the coal in place in the Argentine property and that any loss sustained by it in 1940 from the foreclosure of the mortgage was a long term capital loss which could not be carried forward and deducted from the gross income of 1941.

Between 1918 and 1930 petitioner purchased coal lands, with coal in place and timber on the surface, known as the "Erico" property at a cost as follows:

Coal in place	$139,478.44
Surface	12,661.45
Timber	3,301.77
Total	155,441.66

The mining of coal from the Erico property was discontinued in 1930. The seam of coal on this property was from three to four feet thick, and under the depressed conditions of the coal industry at that time the mine was not being operated profitably. The petitioner was able to supply the demands of its customers for coal from its other mines. In 1930 most of the equipment was removed from the mine. Some of it was used at other mines operated by the petitioner and the balance was stored in buildings on or near the Erico property. The mine was allowed to fill with water.

The depletion allowed and allowable prior to 1931 with respect to the coal in place on the Erico property was $53,234.48.

The Erico property was sold by the petitioner at public auction in 1941 for $2,000.

In its income tax return for 1941 the petitioner claimed the deduction of a loss from the sale of its Erico property in the amount of $110,694.94,[pg. 186] represented by the difference between an alleged sale price of $2,500 and the "cost or other basis" of $113,194.94. No adjustment of the basis was made for any depreciation ever claimed with respect to the property. In his deficiency notice the respondent held that the sale of the Erico property:

*** constituted a sale of a capital asset and that you incurred a long-term capital loss thereon of $13,963.22, rather than the ordinary loss reported by you of $110,694.94. This revision is premised on the fact that you mined no coal on this property after 1930, and the undepleted cost of your coal in place on that property is held to have become a loss through worthlessness in that year by reason of your abandonment thereof.

During the period January 1, 1939, through July 31, 1941, petitioner was indebted on outstanding interest-bearing obligations as follows:

Description	Principal Percent	Rate of amount of interest obligation
(a) First mortgage, due 1951	6	$970,500.00
(b) General mortgage, due 1951	6	1,921,200.00
(c) Wildwood purchase mortgage	6	900,000.00
(d) Five-year bonds, due 1936	6	400,000.00
(e) Argentine mortgage	6	<*>104,000.00
(f) Five-year notes	6	1,725,000.00
(g) Other notes	6	626,367.98
(h) Accounts payable prior to receivership	6	135,000.00
(i) Unsecured notes at date of receivership	6	200,000.00
Total		6,982,067.98

<*>This obligation was extinguished through foreclosure on October 25, 1940.

The amount of interest which accrued upon petitioner's obligations for 1939 and 1940 was $418,924.08 and $417,884.08, respectively. Interest upon the outstanding bonds (a), (b), (c), (d), and (e) was accrued monthly upon the petitioner's books of account and amounted to $257,742 for 1939 and $256,702 for 1940. Interest upon the company's notes, both secured and unsecured, and upon accounts payable was not accrued upon the petitioner's books of account because not needed as a deduction from gross income, since the company had net losses for those years without the accrual of such interest. In its income tax return for 1939 the petitioner claimed the deduction from gross income of $257,742 of interest accrued upon its books of account. This deduction was disallowed by the respondent in the determination of the net loss of the company for 1939. The interest which accrued for 1940 was not claimed as a deduction from gross income in the return filed and in the determination of the deficiency the respondent has not allowed any deduction for the accrued interest.

The petitioner was placed in receivership by the Court of Common Pleas of Butler County, Pennsylvania, on July 21, 1931. Marten A. Reiber, an attorney of Butler County, was appointed receiver for the company. Thereafter, and until August 1, 1941, the company was operated by Marten A. Reiber, as receiver.[pg. 187]

On March 15, 1941, creditors of petitioner submitted to the court a plan of reorganization. This plan was approved by the court on June 6, 1941, effective on August 1, 1941. The essential provisions of the plan, as presented and as approved, were as follows:

(a) All creditors, both secured and unsecured, waived all claims against the petitioner for accrued interest.

(b) All unsecured creditors were to receive, as settlement in full of their respective claims, 25 percentum of the principal amount of said claims, payment thereof to be made in cash.

(c) Petitioner was to issue bonds secured by a mortgage on all the properties of the corporation as follows:

1. Twenty Year 5% First Mortgage Bonds in the aggregate principal amount of $2,500,000.00 providing for the creation of a Sinking Fund of ten cents (10¢) per net ton on all coal mined from the company's properties.

2. Second Mortgage Twenty-five Year Bonds in the aggregate principal amount of $3,498,000.00 bearing interest at the rate of 1 percentum per annum until all the First Mortagage Bonds were paid or retired, after which time the Second Mortgage Bonds were to bear interest at the rate of 3 percentum per annum.
(d) Holders of common and preferred stock of petitioner were to retain the same number of shares as theretofore held, but were to exchange their old certificates for new certificates carrying slightly revised rights and limitations.

From 1931 to December 31, 1941, the petitioner had outstanding 20,775 shares of common stock and 21,308 shares of preferred stock. Prior to February 1, 1937, more than 50 percent of the outstanding stock was owned by B. D. Phillips and family. Included as holdings of the family of B. D.

Phillips were shares of stock owned by the Pennsylvania Investment & Real Estate Corporation, which was a personal holding company owned 100 percent by B. D. Phillips and his family, and shares of stock owned by T. W. Phillips, Jr., Inc., a Delaware corporation, which was owned by T. W. Phillips, Jr., a brother of D. B. Phillips. On February 1, 1937, the board of directors of T. W. Phillips, Jr., Inc., a resolution authorizing its president or vice president to sell, assign, and transfer any and all stocks, bonds, etc., of the corporation. On February 24, 1937, A. C. Succop purchased from T. W. Phillips, Jr., Inc., the 3,312 shares of common stock and the 4,500 shares of preferred stock of the petitioner owned by it. The purchase price was $1, which was paid by A. C. Succop by his check. Other stock of the petitioner was also purchased by Succop on or about the same time. None of this stock purchased by Succop was transferred into his name on the books of the petitioner corporation because the receiver ruled that he had no authority to make the transfer. Succop was, however, the beneficial owner of the stock which he purchased in 1937, and upon the reorganization of the corporation in 1941 he signed consents with respect to the stock owned by him, accepting the plans of reorganization. Upon the consummation of the plan new shares of stock were issued to Succop equaling the same amount of shares as he beneficially owned prior thereto.

On and after 1937 B. D. Phillips and his family owned 4,728 of the[pg. 188] 20,775 shares of common stock of the petitioner outstanding and 13,680 of the 21,308 shares of the preferred stock. B. D. Phillips and his family therefore owned less than 50 percent of the total number of shares of stock of the petitioner outstanding during the years 1938 to 1941, inclusive.

Both the common and the preferred stock of the petitioner were worthless during the years 1939 and 1940.

When the receiver took charge of petitioner's property in 1931 petitioner had cash on hand in the amount of $8,449.22 and accounts receivable in the amount of $147,335.20. On March 15, 1941, when the plan of reorganization was approved, the receiver had cash on hand in the amount of $717,978.34 and accounts receivable in the amount of $224,270.40. At the present time the petitioner has fully retired its first mortgage bonds issued under the plan of reorganization in the total amount of $2,500,000 and, in addition, has retired approximately $300,000 of the second mortgage bonds.

Conditions in the coal industry improved from 1931 to 1941. Petitioner's sales of coal in 1933 amounted to $752,877.87, in 1938 to $1,305,669.88, in 1939 to $1,408,855.96, in 1940 to $1,649,480.45, and in 1944 to $3,245,113.75.

The amount of the accrued interest which was canceled by creditors pursuant to the reorganization agreement was on March 1, 1941, $3,921,401.94.

OPINION.

Smith, *Judge*:

The first question for consideration is whether the petitioner is entitled to deduct from its gross income of 1941 the full amount of the loss sustained by it from the sale of its Erico property. In its income tax return for 1941 the petitioner claimed the deduction of a loss of $110,694.94. The respondent had disallowed the deduction of $96,731.70 of this amount. The principal part of the loss is based upon the cost of the coal in place in the Erico property. The parties have stipulated that the investment of the petitioner in the coal in place on the property was $139,478.44 and that the depletion allowed and allowable with respect thereto was $53,234.48. The difference between these two amounts is $86,243.96. The respondent contends that this amount of the loss was sustained by the petitioner in 1930 when it abandoned mining operations on the property. The petitioner denies that it abandoned the coal in place or sustained any deductible loss in 1930. The fact shows that the coal seam in the property was from only three to four feet thick; that mining operations from the vein were unprofitable due to the depressed condition of the industry in 1930; and that it could supply the demands of its customers for coal more economically from other mines operated by it. It therefore discontinued the mining operations. It removed much of the equipment from the mine. Some of this was stored in buildings at or near the property. We think that the evidence disproves [pg. 189]the contention of the respondent that the petitioner had abandoned the coal in place in the property in 1930.

The question then arises as to whether the loss, the amount of which is not in dispute, which was sustained by the petitioner from the sale of its Erico property in 1941 for $2,000 was a long term capital loss, as the respondent has determined, or an ordinary loss, as contended by the petitioner. Section 117 (a) (5) of the Internal Revenue Code defines the term "long-term capital loss" as follows:

*** The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such loss is taken into account in computing net income.

Subdivision (1) of section 117 (a) provides:

*** The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l).

The petitioner contends that the "coal in place" in the Erico property was property held by the taxpayer "primarily for sale to customers in the ordinary course of its trade or business." The business of the petitioner was the mining and sale of coal—not the sale of coal which it had purchased from others, but the sale of coal which it produced itself. Coal in place is a part of the realty. It is a part of the realty as much as any fixtures on the property. The petitioner was not engaged in the business of selling real estate or "coal in place." We are of the opinion that the coal in place in the Erico property was not held by the petitioner "primarily for sale to customers in the ordinary course" of its trade or business. Cf.*Caroll* v. *Commissioner* (C. C. A., 5th Cir.), 70 Fed. (2d) 806.

There remains to be considered whether the Erico property was of a character "which is subject to the allowance for depreciation provided in section 23 (l)" of the code. The respondent has determined that the loss sustained by the petitioner from the sale of the Erico property was a long term capital

loss. The petitioner has not shown or attempted to show that any part of the Erico property as subject to an allowance for depreciation. Upon the record made the contention of the respondent that the loss sustained from the sale of the Erico property was a long term capital loss is sustained.

The second question for consideration is the amount of "net operating loss carry-over" from the years 1939 and 1940 which the petitioner is permitted to deduct from the gross income of 1941 under article 121 of the Revenue Act of 1940. The respondent raises no question as to the right of the petitioner to deduct such net operating loss carry-over by reason of the fact that there was a reorganization or recapitalization [pg. 190]of the petitioner in 1941. No new corporation resulted from the reorganization. During the period of receivership the returns were made by the receiver. The income tax return for 1941 was made by the officers of the corporation and covered the entire calendar year. The respondent determined that the petitioner sustained net operating losses for 1939 and 1940 of $12,216.29 and $44,152.29, respectively, and has allowed the deduction of the sum of the two amounts, namely, $56,368.58, from the gross income of 1941. The petitioner claims the deduction of a much larger amount. It makes these two contentions: (1) That the respondent erred in treating a loss sustained by it from the foreclosure of a mortgage on its "Argentine" property in 1940 as a long term capital loss rather than as an ordinary loss; and (2) that the respondent failed to allow the deduction from gross income of accrued interest upon its indebtedness for the years 1939 and 1940, although the petitioner filed returns on the accrual basis for all years.

The petitioner had owned the Argentine property for many years prior to 1940. It ceased mining coal from that property in 1931. The mine was partially dismantled. The mortgagee foreclosed its mortgage on the property in 1940 and the petitioner lost its investment therein. The petitioner makes the same contention with regard to the Argentine property as it makes with regard to the Erico property above referred to. In other words, it contends that the coal in place in the Argentine property was held primarily for sale to its customers in the ordinary course of its business and that when it lost that property it had an ordinary loss. The relevancy of the classification of this loss is due to the fact that section 122 (d) (4) of the Internal Revenue Code, as amended, provides that losses from sales or exchanges of capital assets may not be used in the computation of a net loss carry-over, except to the extent of net gains from sales or exchanges of capital assets within the same year. The petitioner makes no contention that it had any profit from a sale or exchange of a capital asset in 1940. The facts with regard to the loss on its Argentine property in 1940 are in all essential respects the same as those with reference to the claimed loss with respect to the sale of its Erico property in 1941. We hold that the respondent did not err in determining that the loss sustained by the petitioner in 1940 from the foreclosure of mortgage on the Argentine property was a long term capital loss which can not be availed of by it in computing the net loss carry-over.

We now consider the contention of the petitioner with regard to its claim that it is entitled to deduct from the gross income of the years 1940 and 1941 the amount of the accrued interest upon its interest-bearing obligations. The respondent contends that it is not entitled to the deduction, first, upon the ground that there was no probability that the interest would ever be paid and, second, upon the ground that, since the interest was not paid within two and one-half months after [pg. 191]the close of each taxable year, it is not a legal deduction from gross income under section 24 (c), Internal Revenue Code.

In *Zimmerman Steel Co.*, 45 B. T. A. 1041, we held that the taxpayer in receivership was not entitled to deduct interest which accrued upon its interest-bearing obligations because the financial condition of the taxpayer was such as to preclude any reasonable certainty that the interest would be paid in the normal course of business. Our decision in that case was reversed by the Circuit Court of Appeals for the Eighth Circuit, 130 Fed. (2d) 1011, the court saying:

*** "there are no court decisions directly holding that an accrued item of expense may not be deducted when there is no reasonable expectancy that it will be paid." Our own search has confirmed the admission. The law is that if a method of bookkeeping employed by a taxpayer "does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income" (Section 41), and the real facts, not forms of entry, must measure the tax. But where interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy as this taxpayer was obliged to do, can not of itself justify denial of deduction in computing the taxpayer's net income. ***

In *Panhandle Refining Co.*, 45 B. T. A. 651, the taxpayer was a going concern engaged in the business of producing, refining, and marketing oil. Its parent company for many years had made advances to Panhandle on open accounts. At the end of the years involved, Panhandle had assets having a value of approximately $4,000,000. Its deficits were in excess of that amount. It owed its parent almost $6,000,000. We, nevertheless, held that the taxpayer was entitled to deduct accrued interest on its obligations. In*Zimmerman Steel Co., supra* , we differentiated that case from*Panhandle Refining Co., supra* , saying that the*Panhandle Refining Co.* case:

*** involved the right to interest deductions for 1936 and 1937 by debtor taxpayer engaged in the oil business, payments in large amounts on the indebtedness had been made by taxpayer to its creditor each year from 1919 to the close of 1937, the creditor accrued the interest on its books as income, the condition of taxpayer's business was improving, its properties had doubled in value by 1936, increased in value in 1937, and at the time of hearing were in still better condition and of greater value, and its potential earnings were curtailed by proration or a limitation on production then in effect. As therein stated there was obviously no uncertainty as to payment. The case is therefore distinguishable.

In *Central Electric & Telephone Co.*, 47 B. T. A. 434, it was stated:

*** It is a cardinal principle of bankruptcy law that secured claims are entitled, to the extent of the agreed interest accruing during the period of bankruptcy, to the earnings for that period from the pledged assets. The same applies to receiverships. *Rohrer* v.*Deatherage* , 168 N. E. 266; *In re Wakey*, 50 Fed. (2d) 869; *American Iron &Steel Mfg. Co.* v. *Seaboard Airline Railway Co.*, 233 U. S. 261; *Mortgage Loan Co.* v. *Livingston*, 45 Fed. (2d) 28; *Ticonic Bank* v. *Sprague*, 303 U. S. 406. The interest is entitled to the same priority as the principal; *Consolidated Rock Co.* v.*DuBois* , 312 U. S. 510; and the current earnings of the secured assets are applicable to the interest accruing upon the secured obligation.*Sexton* v. *Dreyfus*, 219 U. S. 339.[pg. 192]

In I. T. 3635, Cumulative Bulletin, 1944, p. 101, the question propounded was whether interest which accrued during the years 1939 and 1940 on the obligations of a railroad which employed the accrual method of accounting was deductible. The financial condition of the railroad was such that there

was no reasonable expectation that it would pay the accrued interest in full. The railroad filed a petition in 1935 under section 77 of the Bankruptcy Act pertaining to railroads, to be effective as of January 1, 1939. The old bonds were to be exchanged for securities with a smaller rate of interest. The I. T. holds that the interest would continue to accrue as a deduction until the date of the transfer of the corporate assets to the reorganized corporation, saying:

It is held that the interest on the obligations of the M Railroad Co. continues to accrue as a deduction until the date of the transfer of the corporate assets to the reorganized corporation, since (1) the obligation to pay interest runs until the debt is extinguished by the exchange of the obligations of the debtor corporation, for obligations of the reorganized corporation, and (2) the doubt as to the collectibility of such interest is not such a contingency as postpones the accrual of the liability until the contingency is resolved: Accordingly, the full amount of interest accrued on the M Railroad Co.'s obligations which were outstanding during the years 1939 and 1940 is allowable as a deduction for Federal income tax purposes for the respective years of accrual. The proposed plan of reorganization under which the obligations are to be replaced by new securities bearing reduced interest rates does not affect the accrual of interest, for Federal income tax purposes, for the years under consideration.

The facts in the case at bar are more like those which obtained in*Panhandle Refining Co., supra* , than in *Zimmerman Steel Co., supra.* Unquestionably, the petitioner was in a better financial condition in 1941 than in any prior year, although it owed a large amount of accrued interest upon its outstanding obligations. Its sales of coal in 1933 amounted to $752,877.87, in 1939 to $1,408,855.96, in 1940 to $1,649,480.45, in 1941 to $2,129,591.33, and in 1944 to $3,245,113.75.

Although the creditors of the petitioner corporation canceled the interest which was due them in consideration of receiving new obligations of the petitioner, we do not think that this has any material bearing upon the right of the petitioner to accrue interest upon its outstanding debt for the years 1939 and 1940. Those years stand by themselves. Practically all of the interest-bearing obligations of the petitioner in 1939 and 1940 were secured by mortgage. The payment of interest upon its mortgage indebtedness was as much an obligation of the petitioner as the payment of the principal. We see no reason for disallowing the deduction of any part of the interest which accrued upon its outstanding indebtedness unless it be that the petitioner is barred from the deduction of all or any part of it by reason of section 24 (c) of the Internal Revenue Code.

At the hearing of this proceeding the respondent contended that at least a part of the accrued interest was not deductible by reason of the fact that more than 50 percent of the outstanding stock of the petitioner[pg. 193] was owned by B. D. Phillips and his family. The evidence shows that during the years 1939 and 1940 B. D. Phillips and his family owned 4,728 out of 20,775 shares of the common stock of the petitioner outstanding and 13,680 out of 21,308 shares of preferred stock outstanding. Of the combined amounts of stock outstanding it is thus seen that B. D. Phillips and his family owned less than 50 percent of the total. It is to be noted, however, that section 24 (b) (1) (B) provides:

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.

The question arises therefore as to whether B. D. Phillips and family owning more than 50 percent of the preferred stock and about 25 percent of the common stock had an ownership of more than 50 per-centum in value of the total outstanding stock. The petitioner contends that it did not because both its common and preferred stock had no fair market value and, in fact, were worthless during 1939 and 1940. The balance sheets of the petitioner at the end of 1939 and 1940 would indicate that the stock was worthless for all practicable purposes. The transaction also by which A. C. Succop acquired a large amount of the common and preferred stock in 1937 upon a payment of only one dollar would indicate the worthlessness of the stock. Section 24 (c) of the Internal Revenue Code provides as follows:

(c) Unpaid Expenses and Interest.—In computing net income no deduction shall be allowed under section 23 (a), relating to expenses incurred, or under section 23 (b), relating to interest accrued—

> (1) If such expenses or interest are not paid within the taxable year or within two and one half months after the close thereof; and
>
> (2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and
>
> (3) If, at the close of the taxable year of the taxpayer or at any time within two and one half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24 (b).

The question as to whether the petitioner has proved that B. D. Phillips and family owned less than 50 percent "in value" of the outstanding stock of the petitioner during the years 1939 and 1940, when the stock was either worthless or had only a nominal value, is a dialectic one which, in the circumstances of this case, we do not find it necessary to decide. The respondent has determined that the petitioner had adjusted net income for 1941 of only $234,878.31. If the petitioner is entitled to deduct a carry-over loss from prior years exceeding that amount the petitioner will have no income tax liability for 1941.

The deduction of interest under section 23 (c), Internal Revenue Code, is not precluded from deduction by section 24 (c) when the[pg. 194] interest is owed to someone other than a member of the stockholder's family. The stipulated facts show that the accrued interest on the petitioner's obligations owed to others than B.D. Phillips and family amounted to $122,802 for 1939 and $121,762 for 1940. We hold that these amounts are legal deductions from gross income in determining the net loss carry-over for those years.
Reviewed by the Court.

Decision will be entered under Rule 50.

Murdock, *J.*, concurs only in the result.

COMMISSIONER V. P.G. LAKE, INC., CITE AS 1 AFTR 2D 1394 (78 S. CT. 691)

Case Information:

Code Sec(s):
Court Name: U. S. Supreme Court,
Docket No.: No. 108,
Date Decided: 04/14/1958
Prior History: Reversing 5 Cir.:
Tax Year(s): Years 1948, 1949, 1950, 1951.
Disposition: Decision for Government.
Cites: 1 AFTR 2d 1394, 356 US 260, 78 S Ct 691, 2 L Ed 2d 743, 58-1 USTC P 9428.

OPINION

John N. Stull, Washington, D. C., for Petitioners.

Harry C. Weeks, Fort Worth, Texas, and J. Paul Jackson, Dallas, Texas, for Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit.

Mr. JUSTICE DOUGLAS delivered the opinion of the Court.

We have here, consolidated for argument, five cases involving an identical question of law. Four are from the Tax Court whose rulings may be found in 24 T.C. 1016 (the Lake case), 24 T.C. 818 (the Fleming case), 24 T.C. 1025 (the Weed case). (Its findings and opinion in the Wrather case are not officially reported.) Those four cases involved income tax deficiencies. The fifth, the O'Connor case, is a suit for a refund originating in the District Court. 143 F. Supp. 240 [50 AFTR 108]. All five are from the same Court of Appeals, 241 F.2d 71 [50 AFTR 1585], id., p. 65, id., p. 78, id., p. 84, id., p. 69. The cases are here on petitions for certiorari which we granted because of the public importance of the question presented. 353 U.S. 982.

The facts of the Lake case are closely similar to those in the Wrather and O'Connor cases. Lake is a corporation engaged in the business of producing oil and gas. It has a seven-eights working interest 1 in two commercial oil and gas leases. In 1950 it was indebted to its president in the sum of $600,000 and in consideration of his cancellation of the debt assigned him an oil payment right in the amount of $600,000, plus an amount equal to interest at 3 percent a year on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to the taxpayer's working interest in the two leases. At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years.

In its 1950 tax returns Lake reported the oil payment assignment as a sale of property producing a profit of $600,000 and taxable as a long-term capital gain under § 117 of the Internal Revenue Code [pg. 1396] of 1939. The Commissioner determined a deficiency, ruling that the purchase price (less deductions not material here) was taxable as ordinary income, subject to depletion. The Wrather case has some variations in its facts. In the O'Connor case the assignors of the oil payments owned royalty interests 2 rather than working interests. But these differences are not material to the question we have for decision.

The Weed case is different only because it involves sulphur rights, rather than oil rights. The taxpayer was the owner of a pooled overriding royalty in a deposit known as Boling Dome. 3 The royalty interest entitled the taxpayer to receive $0.00966133 per long ton of sulphur produced from Boling Dome, irrespective of the market price. Royalty payments were made each month, based on the previous month's production.

In 1947, the taxpayer, in order to obtain a sure source of funds to pay his individual income taxes, agreed with one Munro, his tax advisor, on a sulphur payment assignment. The taxpayer assigned to Munro a sulphur payment totaling $50,000 and consisting of 86.254514 percent of his pooled royalty interest, which represented the royalty interest on 6,000,000 long tons of the estimated remaining 21,000,000 long tons still in place. The purchase price was paid in three installments over a three-year period. Most of the purchase price was borrowed by Munro from a bank with the sulphur payment assignment as security. The assigned sulphur payment right paid out within 28 months. The amounts received by the taxpayer in 1948 and 1949 were returned by him as capital gains. The Commissioner determined that these amounts were taxable as ordinary income, subject to depletion.

The Fleming case is a bit more complicated and presents an additional question not in the other cases. Here oil payment assignments were made, not for cash but for real estate. Two transactions are involved. Fleming and others with whom he was associated made oil payment assignments, the rights and interests involved being held by them for productive use in their respective businesses of producing oil. Each oil payment was assigned for an interest in a ranch. Each was in an amount which represented the uncontested fair value of the undivided interest in the ranch received by the assignor, plus an amount equal to the interest per annum on the balance remaining unpaid from time to time. The other transaction consisted of an oil payment assignment by an owner of oil and gas leases, held for productive use in the assignor's business, for the fee simple title to business real estate. This oil payment assignment, like the ones mentioned above, was in the amount of the uncontested fair market value of the real estate received, plus interest on the unpaid balance remaining from time to time.

[1] First, as to whether the proceeds were taxable as long term taxable gains under § 117 4 or as ordinary [pg. 1397] income subject to depletion. The Court of Appeals started from the premise, laid down in Texas decisions, see especially Tennant v. Dunn, 130 Tex. 285, 110 S. W.2d 53, that oil payments are interests in land. We too proceed on that basis; and yet we conclude that the consideration received for these oil payment rights (and the sulphur payment right) was taxable as ordinary income, subject to depletion.

The purpose of § 117 was "to relieve the taxpayer from *** excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." See Burnet v. Hormel, 287 U. S. 103 [11 AFTR 1085], 106. And this exception has always been narrowly construed so as to protect the revenue against artful devices. See Corn Products Refining Co. v. Commissioner, 350 U. S. 46 [47 AFTR 1789], 52.

We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. The pay-out of these particular assigned oil payment rights could be ascertained with considerable accuracy. Such are the stipulations, findings, or clear inferences. In the O'Connor case, the pay-out of the assigned oil payment right was so assured that the purchaser obtained a $9,990,350 purchase money loan at 31/2 percent interest without any security other than a deed of trust of the $10,000,000 oil payment right, he receiving 4 percent from the taxpayer. Only a fraction of the oil or sulphur rights were transferred, the balance being retained. 5 Except in the Fleming case, which we will discuss later, cash was received which was equal to the amount of the income to accrue during the term of the assignment, the assignee being compensated by interest on his advance. The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

These arrangements seem to us transparent devices. Their forms do not control. Their essence is determined not by subtleties of draftsmanship but by their total effect. See Helvering v. Clifford, 309 U. S. 331 [23 AFTR 1077]; Harrison v. Schaffner, 312 U. S. 579 [25 AFTR 1209]. We have held that if one, entitled to receive at a future date interest on a bond or compensation for services, makes a grant of it by anticipatory assignment, [pg. 1398] he realizes taxable income as if he had collected the interest or received the salary and then paid it over. That is the teaching of Helvering v. Horst, 311 U. S. 112 [24 AFTR 1058]. And Harrison v. Schaffner, supra; and it is applicable here. As we stated in Helvering v. Horst, supra, 117, "The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them." There the taxpayer detached interest coupons from negotiable bonds and presented them as a gift to his son. The interest when paid was held taxable to the father. Here, even more clearly than there, the taxpayer is converting future income into present income.

[2] Second, as to the Fleming case. The Court of Appeals in the Fleming case held that the transactions were tax-free under § 112 (b)(1) which provides:

"No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment." 53 Stat. 37.
In the alternative and as a second ground, it held that this case, too, was governed by § 117.

We agree with the Tax Court, 24 T. C. 818, that this is not a tax-free exchange under § 112 (b)(1). Treasury Regulations 111, promulgated under the 1939 Act, provide in § 39.112 (b)(1) — 1 as respects the words "like kind," as used in § 112 (b)(1), that "One kind or class of property may not *** be exchanged for property of a different kind or class." The exchange cannot satisfy that test where the effect under the tax laws is a transfer of future income from oil leases for real estate. As we have seen, these oil payment assignments were merely arrangements for delayed cash payment of the purchase price of real estate, plus interest. Moreover, § 39.112 (a) — 1 states that the "underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated." Yet the oil payment assignments were not conversions of capital investments, as we have seen.

Reversed.

1
An oil and gas lease ordinarily conveys the entire mineral interest less any royalty interest retained by the lessor. The owner of the lease is said to own the "working interest" because he has the right to develop and produce the minerals.

In Anderson v. Helvering, 310 U. S. 404 [24 AFTR 967], we described an oil payment as "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced." Id., at 410. A royalty interest is "a right to receive a specified percentage of all oil and gas produced" but, unlike the oil payment, is not limited to a specified sum of money. The royalty interest lasts during the entire term of the lease. Id., at 409.

2
See note 1, supra.

3
Boling Dome is a tract composed of various parcels of land. The owners of the royalty interests in sulphur produced from the separate parcels entered into a pooling agreement by which royalties from sulphur produced anywhere in Boling Dome were distributed pro rata among all the royalty interest holders. In that sense was the interest of each "pooled."

4
Section 117(a)(1) provides in relevant part:

"The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the

taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1) ... or real property used in the trade or business of the taxpayer." 53 Stat. 50, as amended, 56 Stat. 845.

Section 117(a)(4) provides:

"The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income." 53 Stat. 51, as amended, 56 Stat. 843.

Section 117(b) provides:

"In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

"100 per centum if the capital asset has been held for not more than 6 months;

"50 per centum if the capital asset has been held for more than 6 months." 53 Stat. 843.

5
Until 1946 the Commissioner agreed with the contention of the taxpayers in these cases that the assignment of an oil payment right was productive of a long-term capital gain. In 1946 he changed his mind and ruled that "consideration (not pledged for development) received for the assignment of a short-lived in-oil payment carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands." G. C. M. 24849, 1946-1 Cum. Bull. 66, 69. This ruling was made applicable "only to such assignments made on or after April 1, 1946," I. T. 3895, 1948-1 Cum. Bull. 39. In 1950 a further ruling was made that represents the present view of the Commissioner. I. T. 4003, 1950-1 Cum. Bull. 10, 11, reads in relevant part as follows:

"After careful study and considerable experience with the application of G. C. M. 24849, supra, it is now concluded that there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights. It is, therefore, the present position of the Bureau that the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.

"Notwithstanding the foregoing, G. C. M. 24849, supra, and I. T. 3935, supra, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property."

The pre-1946 administrative practice was not reflected in any published ruling or regulation. It therefore will not be presumed to have been known to Congress and incorporated into the law by re-enactment. See Helvering v. N. Y. Trust Co., 292 U. S. 455 [13 AFTR 1184], 467-468. Cf. United States v. Leslie Salt Co., 350 U. S. 383 [48 AFTR 693], 389-397. Moreover, prior administrative practice is always subject to change "through exercise by the administrative agency of its continuing rule-making power." See Helvering v. Reynolds, 313 U. S. 428, 432 [25 AFTR 1250].

REVENUE RULING 72-117

In 1965, the taxpayer acquired as an investment unimproved real estate. In 1970, the property was sold at a gain to a governmental authority under threat of condemnation. The amount received for the property was immediately reinvested in interests in overriding oil and gas royalties, subject to depletion allowances.

Held, the overriding oil and gas royalties are interests in real property. Revenue Ruling 55-526, C.B. 1955-2, 574, and Revenue Ruling 68-226, C.B. 1968-1, 362. Accordingly, there was a replacement with "like kind" property under section 1033(g) of the Internal Revenue Code of 1954. If all of the other requirements of section 1033(a) of the Code are satisfied, the gain qualifies for nonrecognition under section 1033 of the Code.

REVENUE RULING 68-331

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the position set forth in E.T. 4093, C.B. 1952-2, 130.

This Revenue Ruling relates to whether a taxpayer's exchange qualifies as an exchange with respect to which no gain or loss is recognized under section 1031(a) of the Internal Revenue Code of 1954. The taxpayer exchanged his interest in a producing lease of an oil deposit in place (not including personal property, stock in trade, or other property held primarily for sale), extending until the exhaustion of the deposit, for a fee interest in an improved ranch.

Section 1031 of the Code provides, in part, as follows:

(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND.-No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale * * *) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Section 1.1031(a)-1 of the Income Tax Regulations, states, in part:
*
(b) As used in section 1031(a), the words `like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. * * *

(c) No gain or loss is recognized if * * * (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or exchange improved real estate for unimproved real estate;* * *.

Section 1031(a) of the Code does not apply to stock in trade or other property held primarily for sale or to property held for personal use.

The interest of a lessee in a producing oil lease is an interest in real property for Federal income tax purposes. See Rev. Rul. 68-226, page 362, this Bulletin.

In Kate J. Crichton v. Commissioner , 42, B.T.A. 490 (1940), acquiescense, C.B. 1952-1, 2, affirmed, 122 F.(2d) 181 (1941), the United States Board of Tax Appeals held that, under article 112(b)(1)-1 of Regulations 94, which article is substantially the same as section 1.1031(a)-1(b) of the present regulations, an exchange of oil, gas, and mineral rights for an undivided one-half of the fee in a parcel of improved realty was an exchange of properties of a like kind under section 112(b)(1) of the Revenue Act of 1936 (identical to section 1031(a) of the 1954 Code). The United States Circuit of Appeals for the Fifth Circuit, in affirming the decision of the United States Board of Tax Appeals in the Crichton case, stated:

* * the regulation and the interpretation under it, leave in no doubt * * * that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use.

In the Crichton case, the Board of Tax Appeals distinguished its decision in Midfield Oil Co. v. Commissioner , 39 B.T.A. 1154 (1939), acquiescence, C.B. 1939-2, 25, in which it held that an exchange of an oil payment for an overriding oil and gas royalty reserved from the same lease was not an exchange of property of like kind. The Board pointed out that the oil payment was a limited interest in the property, whereas the overriding royalty was to continue so long as oil or gas might be produced. In other words, an oil payment is an interest that is limited to a certain portion of the natural resource, whereas an overriding royalty is attributable to the entire natural resource in the property. Therefore, the decision in the Crichton case is not regarded as affecting the conclusions reached in the Midfield Oil case.

Accordingly, the exchange by the taxpayer of his leasehold interest in a producing oil lease (not including personal property, stock in trade, or other property held primarily for sale), extending until the exhaustion of the deposit, that is held for productive use in trade or business or for investment, for the fee interest in the improved ranch to be held for productive use in trade or business or for investment is an exchange of property for property of a like kind under section 1031(a) of the Code, to the extent of the ranch land and permanent improvements thereon, but not including that part of the ranch property consisting of a personal residence within the meaning of section 1034 of the Code, personal property, stock in trade, or other property held primarily for sale.

REVENUE RULING 55-749

Advice has been requested whether the exchange of perpetual water rights for a fee interest in land under the circumstances set forth below constitutes a nontaxable exchange of property of like kind within the purview of section 1031(a) of the Internal Revenue Code of 1954.

A is the owner in fee of 20 acres of arid land, all of which is in an irrigation district, but he is not entitled to receive water from such district facilities. B has a contract with the irrigation district whereby he has the right to `petition into' such district a specified number of acres of arid land for perpetual irrigation purposes. B has agreed to petition the 20 acres of arid land owned by A into the irrigation district for water facilities in perpetuity in exchange for one half of such land. Under the applicable laws of the state in which the property is located, water rights are considered real property rights.

Section 1031(a) of the Code, regarding the nonrecognition of gain or loss from exchanges solely in kind, states, in part, as follows:

* * * No gain or loss shall be recognized if property for productive use in trade or business or for investment (mot including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanges solely for property of a like kind to be held either for productive use in trade or business or for investment.

Section 39.112(b)(1)-1 of Regulations 118, applicable to section 1031(a) by virtue of Treasury Decision 6091, C.B. 1954-2, 47, provides, in part, that the words `like kind,' as used in section 1031(a) of the Code, have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class.

In the instant case, the fact that the two varieties of property, namely water rights and land, may be legally classified as real property does not of itself signify that the two are property of like nature or character within the meaning of section 1031(a) of the Code. If there be substantial difference in the rights created in and to the respective properties, then the properties are not of like kind. See Wm. Fleming and Bessie M. Fleming et al. , v. Commissioner , 24 T.C. No. 93.

In the Wm. Fleming and Bessie M. Fleming case, supra , the Internal Revenue Service was sustained in the view that an exchange of the fee simple title to a ranch for an in-oil payment right was not an exchange solely in kind under section 112(b)(1) of the 1939 Code. In arriving at its decision, the court stated that in comparing properties to determine their likeness within the meaning of section 112(b)(1) there must be considered not alone the nature and character of the physical properties but also the nature and character of the title conveyed or the rights of the parties therein; that from the applicable regulations the implication is clear that the rights vested in the respective grantees in and to the properties exchanged must be of the same general character or of substantial equality and, if they are not, then the properties exchanged are not of like kind within the meaning of the Code. Under the circumstances in the instant case, where the water right, whatever its size, is in perpetuity, as distinguished from a right to a specific total amount of water or to a specific amount of water for a limited period, the water rights and the land involved are regarded as sufficiently similar to constitute property of like kind within the meaning of section 1031(a) of the Code. See I.T. 4093, C.B. 1952-2, 130.

Accordingly, it is held that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of section 1031(a) of the Internal Revenue Code of 1954, provided the requirements of that section as to holding for productive use in the trade or business or for investment are met

GENERAL COUNSEL MEMORANDUM 39572

Internal Revenue Service (I.R.S.)
General Counsel Memorandum (G.C.M.)
Date Numbered: November 18, 1986
September 17, 1984

Section 1033 — Involuntary Conversion

Charles M. Morgan III
Associate Chief Counsel (Technical)
Attention: Director, Corporation Tax Division

Reference is made to your memorandum dated June 6, 1984, in which you requested our consideration of a request for technical advice made with respect to the above-referenced case.

ISSUES

1. Whether the acquisition of mineral leases within the prescribed time period and subsequent development of the property (including expenditures for intangible drilling costs) will constitute replacement property under section 1033 of the Internal Revenue Code?

2. Whether the acquisition of oil and gas properties through the purchase of partnership interests will constitute replacement property under section 1033 of the Code?

CONCLUSIONS

1. The acquisition of mineral leases within the prescribed time period will constitute replacement property under section 1033 of the Code. The expenditures for intangible drilling costs will constitute replacement property under section 1033 only if (1) the taxpayer capitalizes such costs so that they become part of the taxpayer's bases for the newly-acquired interests in oil and gas and (2) such costs are paid or incurred during the appropriate replacement period.

2. The acquisition of oil and gas properties through the purchase of partnership interests will not constitute replacement property under section 1033 of the Code.

FACTS

The taxpayers, as husband and wife, owned certain property interests (as community property) consisting of interests in developed and undeveloped mineral leases, a fee interest in real property, and personal property (lease and well equipment) associated with several oil and gas wells. The taxpayers held these properties for productive use in their oil and gas business. In 1981, these properties were the subject of condemnation proceedings which resulted in a $700,000 award for the taxpayers. They received the $700,000 award in 1982. In that year, however, the taxpayers filed a suit contesting the amount of the award.

The taxpayers intend to reinvest the proceeds of the involuntary conversion within the prescribed time period in: (1) interests in oil and gas in place, expenditures for intangible drilling and development costs to be incurred in developing such interests and, if necessary, equipment needed to produce oil and gas; and (2) interests in limited partnerships, the assets of which are primarily invested in interests in oil and gas in place, and which may involve expenditures for intangible drilling and development costs and equipment necessary to produce oil and gas.

The taxpayers request rulings that (1) the acquisition of mineral leases within the prescribed time period and subsequent development of the property (including expenditures for intangible drilling costs) and (2) the acquisition of oil and gas properties through the purchase of partnership interests, will constitute replacement property under section 1033 of the Code.

ANALYSIS

1. Section 1033 Generally

Section 1033(a)(2) of the Code provides, in pertinent part, the general rule that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money, the gain (if any) shall be recognized except to the extent provided in section 1033(a)(2)(A).

Section 1033(a)(2)(A) of the Code provides that if the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property.

Section 1033(g)(1) provides a special rule that if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1033(g)(4) indicates that the converted property must be replaced within the period commencing with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending three years after the close of the first taxable year in which any part of the gain upon the conversion is realized. For all other involuntary conversions, section 1033(a)(2)(B)(i) provides a two-year period in which the converted property must be replaced.

Section 1.1031(a)-1(B) of the Income Tax Regulations states that, as used in section 1031(a), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

As an initial matter, it should be noted that the taxpayers here appear to have received a lump sum condemnation award to compensate them for the taking of various types of property used in their oil and gas business. In particular, the award covers both real property (i.e., the interests in developed and undeveloped mineral leases and the fee interest in real property) and personal property (lease and well equipment).

Rev. Rul. 70-465, 1970-2 C.B. 162, recognizes that where the assets of a going business are sold in a single transaction under threat of condemnation, or are taken by condemnation, for purposes of section 1033, the gain and proceeds attributable to the real property and the gain and proceeds attributable to the other property are to be considered separately. Thus, Rev. Rul. 70-465 holds that an electrical distribution company which sold all of its assets under threat of condemnation, but which was able to apply the sale proceeds to replace its real property only and not its other electrical distribution property, had to allocate the proceeds among all the assets sold and could get section 1033(g) nonrecognition treatment of the gain realized on the involuntarily converted real property only. Applying Rev. Rul. 70-465 to the instant case, we note that the taxpayers will be required to allocate the condemnation award among the real property and personal property that were involuntarily converted. To the extent the proceeds are not applied towards qualified replacement property, the taxpayers will not be afforded section 1033 nonrecognition treatment of any gain realized.

A second point worth noting is that different standards will be applied in determining whether the taxpayers have reinvested the condemnation proceeds in qualified replacement property. Specifically, the more liberal 'like kind' standard set forth in section 1033(g), and defined by Treas. Reg. section 1.1031(a)-1(b), will govern the determination whether the condemnation proceeds allocated to the involuntarily converted real property are to be reinvested in qualified real property. SEE G.C.M. 34651, supra (holding that a taxpayer who reinvested the proceeds from unimproved real estate that was sold under threat of condemnation in interests in overriding oil and gas royalties had met the 'like kind' standard of section 1033(g) and could, therefore, defer recognition of gain). See also Rev. Rul. 68-331, supra . With respect to the taxpayers' personal property that has been involuntarily converted, however, the standard to be applied is that set forth in section 1033(a)(2)(A) of the Code, requiring that the proceeds be used to purchase other property 'similar or related in service or use' to the converted property.

Under the 'like kind' standard, Treas. Reg. section 1.1031(a)- 1(b) indicates that the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. Because this standard has been liberally construed, the replacement of one real property interest held for productive use in trade or business or for investment by another that is similarly held generally would be deemed to fall within the definition of a like kind exchange. As the court stated in Crichton, supra, with respect to the 'like kind' standard under section 112(b)(1), Revenue Act of 1936, forerunner to section 1031:

It will not do for him [the commissioner] to now marshal or parade the supposed dissimilarities in grade or quality, the unlikenesses, in attributes, appearance and capacities, between undivided real interests in a respectively small town hotel, and mineral properties. For the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use.

122 F.2d at 182. Thus, like kind exchanges have been deemed to exist in the following instances: G.C.M. 34651, supra (exchange of undivided interest in unimproved real estate for interest in overriding oil and gas royalties); Rev. Rul. 68-331 (exchange of interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch); Commissioner v. Crichton, supra (undivided interest in minerals in unimproved country land exchanged for undivided interest in improved city land); Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953) (exchange of an undivided fractional oil, gas, and other mineral interest for overriding royalty and mineral interests).

Based upon the foregoing authorities, we are of the opinion that the taxpayers' proposal to reinvest that portion of the condemnation proceeds that relates to the taxpayers' former real property holdings--that is, the developed and undeveloped mineral leases and the fee interest in real property--in interests in oil and gas in place (which are real property interests for Federal income tax purposes pursuant to Rev. Rul. 68-226) clearly satisfies the 'like kind' standard described above. Thus, such reinvestment would qualify for the nonrecognition treatment provided under section 1033(g) of the Code.

2. Investment of Condemnation Proceeds in Intangible Drilling and Development Costs

The taxpayers also propose to reinvest a portion of the condemnation proceeds in expenditures for intangible drilling and development costs (IDC) to be incurred in developing the newly- acquired oil and gas leases. They contend that such expenditures will constitute replacement property under section 1033 because IDC can be capitalized, pursuant to section 263(c), and recovered through depreciation or depletion, pursuant to Treas. Reg. section 1.612-4, and, hence, that such costs are similar to improvements to real property. We believe the taxpayers position to be supportable with some modification as discussed below.

Section 263(a)(1) provides the general rule that no deduction shall be allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treas. Reg. section 1.263(a)-1(b) states that, in general, capital expenditures

include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.

Section 263(c) states notwithstanding subsection (a), regulations shall be prepared by the Secretary corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress. Treas. Reg. section 1.263(c)-1 refers to Treas. Reg. section 1.612-4 for rules relating to the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells.

From the foregoing statutory and regulatory provisions, it seems clear that IDC must be capitalized and added to a taxpayer's basis in property to which such costs relate unless the taxpayer makes an election pursuant to section 263(c) to deduct such expenses as they are incurred or paid. See G.C.M. 33536 at 8, I-2220 (June 19, 1967), where we noted that, in a section 1031 exchange of leasehold interests in oil and gas, it is not proper to break down the depletable basis of the interest into leasehold costs and capitalized intangibles. In that G.C.M. we discussed the nature of IDC:

Those portions of the well costs which are represented by intangible expenditures exist only as a betterment of the leasehold since they have no salvage value. CFR sec. 1.612- 4(a)(3). For example, well costs may be composed of expenditures for clearing ground, draining, road-making, excavation and grading, as well as the cost of drilling the well itself. CFR sec. 1.612-4(b)(1). These items have no value apart from the leasehold which they enhance, and it is factually impossible to effect an exchange of these items apart from the leasehold.

Thus, while the expenditures incurred for IDC generally do not result in the typical physical improvement to land that one thinks of when discussing improvements, it is apparent that such costs result in a betterment that readies the oil and gas interest for production.

We know of no authority directly on point which has allowed condemnation proceeds that are applied towards IDC, incurred in connection with the development of an interest in oil and gas, to be considered qualified replacement property under section 1033(g). We believe, however, that such a result is not unwarranted in the light of analogous precedent and the legislative intent behind the enactment of section 1033.

In Rev. Rul. 59-8, 1959-1 C.B. 202, the Service ruled (1) that the destruction by hail of a standing crop of wheat constitutes an involuntary conversion to which section 1033 may apply, (2) that the gain realized from the receipt of insurance proceeds on account of such destruction is not recognized when an amount equal to such proceeds is used to purchase a replacement standing crop or harvested crop within the requisite replacement period, and (3) that the use of the insurance proceeds to cover the costs of planting a new crop does not constitute the acquisition of replacement property under section 1033.

In Rev. Rul. 62-161, 1962-2 C.B. 175, considered in * * * service or use to apple orchards requisitioned by a state agency through its eminent domain power. The costs incurred in connection with bringing the young apple trees to productive maturity were held not to be qualified replacement costs.
Rev. Rul. 81-279, 1981-2 C.B. 163, considered in * * *, G.C.M. 38558, I-123-79 (Nov. 4, 1980), modified Rev. Rul. 59-8 and amplified Rev. Rul. 62-161, holding that:

The costs of planting and raising a similar new crop to replace a standing crop involuntarily converted under section 1033 of the Code qualify as replacement costs under section 1033(a)(2)(A) for farmers using the crop method for such costs pursuant to section 1.162-12(a) of the regulations, to the extent that they are expended to bring the crop to the same level of maturity as the converted crop and provided they are incurred within the time specified in section 1033(a)(2)(B). 1981-2 C.B. at 164.

The rationale for the holding in Rev. Rul. 81-279 was that, where the farmer elected to use the crop method under Treas. Reg. section 1.162-12(a), the expenses of planting and raising crops became capital in nature and could be considered as part of the cost of the crops under section 1012 and for purposes of section 1033(a)(2)(A).
G.C.M. 38558, which considered Rev. Rul. 81-279, provides what we believe to be an even more significant reason for the ruling's conclusion. Specifically, we relied upon the analysis in * * *, G.C.M. 37324, I-294-75 (Nov. 15, 1977), to find that section 1033 was intended to be a relief provision and that permitting a taxpayer to receive nonrecognition treatment was consistent with the legislative policy behind section 1033, with respect to money received to compensate for costs that the taxpayer was required to expend to replace property involuntarily converted.

G.C.M. 37324 involved a farmer who was ordered by the Federal government to destroy a number of diseased feeder pigs. The taxpayer was indemnified for the destruction of his pigs and, with the proceeds therefrom, the taxpayer replaced the destroyed feeder pigs with an equal number of weanling pigs. The taxpayer subsequently incurred certain expenses to raise the weanling pigs to bring them to the same level of maturity as the destroyed feeder pigs. We expressed the opinion that the purchase of weanling pigs constituted replacement property 'similar or related in service or use' to the destroyed feeder pigs under section 1033(a)(2)(A). Moreover, we stated that because Treas. Reg. section 1.162-12(a) granted the taxpayer the option to expense or capitalize the costs of raising the weanling pigs, such costs would be includible in the pigs' bases if the taxpayer elected to capitalize the costs, and, thus, could be considered as part of the replacement cost under section 1033(a)(2). In conclusion, we held that:

If the taxpayer-farmer here elected to capitalize such costs, and they were incurred within the replacement period specified in Code section 1033(a)(3)(B), we believe that, to the extent that they bring the weanling pigs to the same level of maturity as the destroyed pigs, they are qualified replacement costs for purposes of Code section 1033(a)(3)(A).

G.C.M. 37324 at 6. Furthermore, we stated that this result is consistent with the policy behind section 1033:

In G.C.M. 34651, * * * I-4096 (Oct. 30, 1971), this office stated that the general policy behind the nonrecognition provisions, and specifically Code section 1033, is: 'to relieve the taxpayer from the burden of paying tax on gain that has not resulted in an economic benefit to him, while his money is still invested (in the replacement property) and he does not have the cash representing the realized gain with which to pay the taxes that would

otherwise have been imposed.' Here, the taxpayer is merely trying to restore is prior position. In order to do so, the money received by taxpayer-farmer is necessarily tied up in the purchase of the weanling pigs and the costs of raising them.

G.C.M. 37324 at 6-7.

We believe the aforementioned cases provide ample support for the instant taxpayers' argument that expenditures for IDC can qualify as replacement property under section 1033. As was previously noted, such costs are to be capitalized and become part of the taxpayers' basis for the newly-acquired interests in oil and gas unless the taxpayer specifically elects under section 263(c) and Treas. Reg. section 1.612-4 to deduct such costs. The taxpayers must satisfy two requirements in order to consider IDC as replacement property. First, such costs must be capitalized. Second, such costs must be paid or incurred during the appropriate replacement period. Because the 'like kind' standard applies with respect to the replacement of the converted real property, we do not believe that the amount of the proceeds used for IDC which qualify as replacement property should be limited to that amount necessary to cause the new oil and gas interests to attain the same level of development as the converted interests. Such a requirement would relate to the grade or quality of the replacement property and not to its kind or class, and, as such, does not fall within the definition of 'like kind' property under Treas. Reg. section 1.1031(a)-1(b).

We are of the view that the result reached herein comports with the notion that 'section 1033 was to provide relief for a wronged taxpayer.' G.C.M. 34651 at 7. In this case, like that presented in G.C.M.s 37324 and 38558, the taxpayers are merely attempting to restore their prior position as owners of interests in developed and undeveloped mineral leases by acquiring new mineral leases and incurring expenditures for IDC to develop such interests for productive use in their oil and gas business. There is no indication here that the taxpayers are attempting to strengthen their tax posture so as to be much better off after the condemnation than before without suffering the consequences for which section 1033 was intended to provide relief. See G.C.M. 34651 at 8. Nor is there any evidence that the taxpayers are relying upon section 1033 to change the nature of their investment. Lakritz v. United States, 418 F. Supp. 210, 214 (E.D. Wis. 1976). Thus, we believe the expenditures to be incurred by the taxpayer for IDC may qualify as replacement property under section 1033(g).

3. Investment of Condemnation Proceeds in Limited Partnership Interests

The taxpayers have also indicated their intention to reinvest the proceeds of the involuntary conversion within the prescribed time period in interests in limited partnerships, the assets of which are primarily invested in interests in oil and gas in place, and which may involve expenditures for IDC and equipment necessary to produce oil and gas. We are of the opinion that the taxpayers are incorrect in their assertion that the acquisition of oil and gas properties through the purchase of partnership interests will constitute replacement property under section 1033 of the Code.

That the purchase of an interest in a partnership that owns property similar to the involuntarily converted property is not an investment in property that is 'similar or related in service or use' or of 'like kind' to the converted property is well established. In Rev . Rul. 55-351, 1955-1 C.B. 343, the Service ruled that:

The purchase by a corporation of an interest in a partnership within the time specified in section 112(f)(3)(B) of the Internal Revenue Code of 1939 [predecessor to section 1033], for purposes of replacing property involuntarily converted, is not a purchase of 'other property similar or related in service or use to the property converted,' within the meaning of section 112(f)(3)(A) of the 1939 Code, even though the partnership owns and operates property similar to the property converted.

See also Rev. Rul. 57-154, 1957-1 C.B. 262, considered in * * *, G .C.M. 29431, A-619413 (April 23, 1956) (use of proceeds from condemned real property to purchase interest in partnership that holds real property does not qualify as section 1033 replacement property; however, purchase of an interest in real property as a tenant in common would qualify); Collins v. Commissioner, 29 T.C. 670 (1958) (section 1033 does not apply when a taxpayer, whose property in a poultry business was condemned, used the condemnation award to purchase rental property and a partnership interest in a gasoline service station).

In * * *, G.C.M. 32778, I-1142 (Jan. 30, 1964), we determined that a taxpayer's purchase of two 1/1100th interests in a general partnership, which was formed for the purpose of acquiring the master lease on a particular building, to receive rent under a sublease, and to make distributions of partnership profits, did not qualify as replacement purchases for purposes of section 1033 where the taxpayer's individual interest in real property was involuntarily converted. We provided the following rationale for this conclusion:
A partners' co-ownership right in the partnership property does not vest him with exclusive ownership of any specific firm property or portion thereof but merely with a joint interest in the whole of it. A partner, cannot have any individual interest in any part of the firm property nor deal with it as his own.
The only interest in the partnership which a partner owns separately as distinguished from jointly is his partnership interest, i .e., his right to share in the profits and surplus upon settlement of the firm's obligations as disclosed by a partnership accounting. A partnership interest in general is a capital asset which is separate and distinct from the underlying firm assets. Therefore, purchase of a partnership interest for purposes of replacing property involuntarily converted, is not a purchase of 'other property similar or related in service or use to the property converted,' within the meaning of section 1033 of the 1954 Code, even though the partnership owns and operates property similar to the property converted.

G.C.M. 32778 at 3. Thus, it would appear that our rationale for the conclusion reached in Rev. Rul. 55-351 and its progeny was based upon the premise that the same entity whose property has been involuntarily converted must itself be the owner of the replacement property in which the involuntary conversion proceeds are reinvested. Because a partnership is an entity distinct from the partners who hold the interests therein, and holds property in its own name, we concluded that a person whose property is involuntarily converted cannot replace such property by purchasing an interest in a partnership that holds property similar to that which was converted.

As recently as 1976, the holding of Rev. Rul. 55-351 was extended to a situation in which the 'like kind' standard rather than the 'similar or related in service or use' standard was applied. In M.H.S. Company v. Commissioner, T.C.M. 1976-165, 45 T.C.M. (P-H) paragraph 76,165 (1976), aff'd, 575

F.2d 1177 (6th Cir. 1978), petitioner reinvested the proceeds it received upon the condemnation of real property held by it for productive use in its trade or business or for investment in a joint venture that purchased real estate. The court was thus presented with the issue whether the proceeds received pursuant to the condemnation award were reinvested in 'like kind' property as required by section 1033(g) of the Code. The court first observed that '[u]nder Tennessee law, an interest acquired in a partnership is an interest in personality regardless of the fact that the underlying assets of the partnership include interests in real property.' 45 T.C.M . (P-H) at 76-734. In determining that the petitioner did not acquire 'like kind' property, the court stated:

Section 1033 is not applicable if one kind of property is exchanged for another kind. An exchange of an interest in real property for an interest in personal property is not an exchange of 'like kind' property since the property interests are not of the same kind or class . . . . The differences in a partnership interest and ownership of real property are substantial and an investment of funds from a condemnation of real estate in a partnership interest does not result in the continuity in the nature of the investment necessary to bring the transaction within the nonrecognition of gain provisions of section 1033. See Estate of Rollin E. Meyer, Sr., 58 T.C. 311, 314 (1972). Id. at 76-734, 76-735. See also Lakritz v. United States, 418 F. Supp. 210 (E.D. Wis. 1976), in which the court held the taxpayers' reinvestment of fire insurance proceeds, received because of the destruction of the taxpayers' business building, in shares of real estate investment trusts was not a reinvestment in property of 'like kind' or 'similar or related in service or use.'

The clear import of [section 1033(a)(2)(A)] is that the taxpayer himself (or his straw party) must directly purchase the replacement property to qualify for nonrecognition treatment, and cannot indirectly achieve this same result by having his controlled corporation make the acquisition.
418 F. Supp. at 213, quoting Feinberg v. Commissioner, 377 F.2d 21 (8th Cir. 1967). The court in Lakritz also noted that '[t]he 'like kind' standard of section 1031 is broader than and inclusive of the 'similar or related in service or use' test of section 1033' and that if a 'transfer cannot meet the broader 'like kind' language of section 1033, it can hardly be argued that it meets the narrower standard of 'similar or related in service or use.'' 418 F. Supp. at 214. Thus, the court concluded that the taxpayer had 'taken advantage of the involuntary conversion of his investment to change the nature of that investment.' Id.

We have located only one situation in which the Service permitted a taxpayer who purchased an interest in a partnership that owned property similar to the taxpayer's condemned property to have nonrecognition treatment under section 1033(a)(2)(A). We believe that situation to be distinguishable from the instant case and the foregoing authorities. In Rev. Rul. 70-144, 1970-1 C.B. 170, a taxpayer, an individual, owned property which was condemned by the appropriate governmental authority. The taxpayer also owned a 50 percent interest in a partnership that owned property similar to the condemned property. During the replacement period, the taxpayer purchased the remaining 50 percent interest in the partnership. The Service held that this purchase qualified as replacement property under section 1033(a)(2)(A) because the purchase of the remaining partnership interest resulted in a termination of the partnership and the ownership by the individual taxpayer of all of the partnership property including the property that was similar to the condemned property. Thus, this set of facts was distinguished from Rev. Rul. 55-351 and Rev. Rul. 57-154 because the taxpayer here did not hold a mere interest in a partnership, but rather became the sole owner of the partnership's assets. See also * * *, G.C.M. 30909 at 1-2, A-627905 (Oct. 2, 1958), which considered a proposed ruling letter involving the same facts as Rev. Rul. 70-144 ('[T]he service haS regarded a partnership as an entity for purposes of section 1033 * * * Therefore, an interest in a partnership should not be regarded as an interest in the underlying property, and, accordingly, the taxpayer's acquisition of the remaining partnership interest would amount to acquiring the underlying property outright and for the first time').

Based upon the foregoing authorities, we think there can be no doubt in this case that the instant taxpayers' proposal to reinvest the proceeds received because of the condemnation of its real property interests in limited partnerships whose assets are primarily invested in real property interests will not satisfy the 'like kind' standard under section 1033(g). The taxpayers here would be replacing their real property with personal property contrary to Treas. Reg. section 1.1031(a)-1(b) which makes it clear that one kind or class of property may not be exchanged for property of a different kind or class and achieve nonrecognition treatment.

The taxpayers argue further, however, that because tax legislation has been enacted after the issuance of Rev. Rul. 55-351 (e.g., sections 613A(c)(6)(B)(ii), 613A(c)(7)(D), and 4996(a)(1)(C)) which treats a partner of a partnership holding oil and gas properties as the owner of the oil and gas properties, that Rev. Rul. 55-351 is no longer valid and that the partnership interests will, therefore, qualify as replacement property under section 1033. We believe this argument to be insupportable.

The taxpayers are referring to those sections of the Internal Revenue Code which allow the basic principles of taxing partnerships, that establish the partnership as a separate entity, to be disregarded for purposes of computing the percentage depletion deduction. Under the Code sections just cited, as well as section 703(a)(2)(F), the oil and gas depletion deduction is to be separately accounted for and passed through to the partners. The rationale for ignoring the partnership entity in this situation is to avoid double deductions that would result to the partnership and its partners. It is well known that the law of partnership taxation requires that, in certain circumstances, the partnership is to be viewed as an entity separate from its partners (i.e., for adopting a method of accounting or a taxable year, to make certain elections, for computing taxable income). In other situations, the law of partnership taxation views the partnership as an aggregate of its partners (i.e., only the partners and not the partnership are subject to taxation of partnership income, the depletion deduction may be taken by the partners only), [FN8] We do not believe that the fact that a partnership may be ignored for purposes of computing the depletion deduction requires a determination that a partnership is to be ignored in determining whether a taxpayer has invested the proceeds from involuntarily converted property in qualified replacement property. Indeed, all of the authority that we have found on this subject leads us to a contrary conclusion.

Moreover, section 1033(a)(2) specifically provides that the taxpayer need not recognize gain if the taxpayer reinvests the involuntary conversion proceeds in 'other property similar or related in service or use to the property so converted, or PURCHASES STOCK IN THE ACQUISITION OF CONTROL OF A CORPORATION OWNING SUCH OTHER PROPERTY.' It seems clear from the foregoing provision that Congress intended that only the CORPORATE entity should be disregarded and only when the taxpayer had control thereof. It is apparent that Congress could easily have drafted this code section so as to apply to partnerships as well. Having failed to do so, we decline to interpret this statute in the manner suggested by the taxpayers so as to broaden the applicability of section 1033.

Finally, as previously discussed, to the extent the taxpayers receive condemnation proceeds that are allocated to the condemned personal property (i.e., the lease and well equipment), the taxpayers, pursuant to section 1033(a)(2)(A), must reinvest such proceeds in property that is 'similar or related in service or use' to the condemned property. Whether replacement property acquired by an owner-user of property is similar in service or use to the converted property requires a determination that the physical characteristics and uses of the converted and replacement properties are closely similar. See * * *, G.C.M. 36718, I-464-74 (May 4, 1976). Under this test, the taxpayers will receive nonrecognition treatment of the gain realized upon the conversion of their personal property only if the condemnation proceeds, as allocated, are reinvested in other lease and well equipment that are physically similar to the converted property and used for a similar purpose. To the extent the proceeds from such converted property are invested in interests in limited partnerships whose assets may be used to purchase equipment necessary to produce oil and gas, such property will not be qualified replacement property. It seems clear that there are significant physical differences between oil and gas equipment, being tangible personal property, and an interest in a limited partnership, being intangible personal property. Moreover, while the equipment was used in the taxpayers' oil and gas business, limited partnership interests generally are held for investment. Thus, as to this final issue, we believe the taxpayers' request for a ruling that the acquisition of oil and gas properties and equipment through the purchase of partnership interests constitute qualified replacement property under section 1033 of the Code must be denied.

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TAX DEFERRED EXCHANGES IN THE VIRGIN ISLANDS, GUAM AND THE NORTHERN MARIANA ISLANDS (ARTICLE)

The United States Treasury ("Treasury") recently expanded the range of investment property located outside the United States for which tax deferral may be permitted under Internal Revenue Code ("Code") Section 1031. Since the Internal Revenue Service's issuance of a private letter ruling in 1990 approving a tax deferred exchange of property located in the U.S. for property in the U.S. Virgin Islands, the §1031 oriented tax community has generally understood that a §1031 exchange involving property located in the U.S. for property located in the Virgin Islands could be accomplished, but what about the other U.S. Territories? In 2005, the Treasury adopted a temporary regulation under Code §935 that appears to extend the application of §1031 deferral to exchanges of U.S. property to property situated in Guam and the Northern Mariana Islands.

The fact that §1031 might apply to any exchange of property located within the U.S. for property outside the U.S. is a bit surprising given that the Statute itself at subparagraph (h) flatly states that "[r]eal property located in the United States and real property located outside the United States are not property of a like kind." The Code's specific definition of "United States" when used to describe a geographic area includes only the 50 states and the District of Columbia. See Code §7701(a)(9). So, how can property inside the U.S. ever be like-kind to property outside the 50 states? The answer is hinted at in the legislative history accompanying the adoption of §1031(h) where the committee recommended the adoption of that subsection stating that "no inference [from the adoption of 1031(h)] is intended to override or otherwise modify Code Sec. 932" (Conference Committee Report No. 101-386 (PL 101-239) at p. 614). Code §932 provides rules intended to coordinate the application of tax U.S. tax laws with those of the Virgin Islands. It's important to understand that the Virgin Islands, although a U.S. Territory, has an independently elected government and taxing powers independent of the U.S. Consequently, coordination of the U.S. income tax laws and those of the Virgin Islands is necessary to avoid confusion and duplication of tax for individuals who are subject to tax in both jurisdictions.

Code §932(a)(3) generally provides that the U.S. shall be treated as including the Virgin Islands if the requirements of §932(a) are met. §932 applies to an individual citizen or resident of the U.S. (other than a bona fide resident of the Virgin Islands during the entire taxable year) who (i) has income derived from sources within the Virgin Islands, or effectively connected with the conduct of a trade or business within such possession, for the taxable year, or (ii) such individual files a joint return for the taxable year with such an individual. Consequently, if a person is subject to the coordinating provisions of §932 (a person subject to tax in both the U.S. and the Virgin Islands) then the term "Unites States", as used in the Code, includes the Virgin Islands. §932(c) provides reciprocal treatment for bona fide residents of the Virgin Islands. Until recently, only property located in the U.S. Virgin Islands enjoyed this status for purposes of §1031.

Effective April 11, 2005, the Treasury adopted temporary regulations under §935 that provide identical treatment for residents of Guam and the Northern Mariana Islands. See Treas. Reg. §1.935-1T--Coordination of individual income taxes with Guam and the Northern Mariana Islands (temporary). Accordingly, a U.S. citizen or resident domiciled in the U.S. who exchanges investment property situated in the U.S. for replacement property located in the Virgin Islands, Guam or the Northern Mariana Islands (collectively, the "Coordinated Territories") may do so only if the person is subject to tax in both the U.S. and the respective Coordinated Territory for the year in which the exchange is completed. That would be the case if, for example, the property acquired in Coordinated Territory is expected to produce income taxable in that Coordinated Territory. The same would be true for an individual who is a resident of the Coordinated Territory (although a resident of Guam is a U.S. citizen, they are afforded separate tax treatment if they are a "bona fide resident of the Territory") who could sell property located in the Coordinated Territory for income producing investment property located in the U.S.

The addition of the Northern Mariana Islands and Guam to the list of properties that may be acquired in a like-kind exchange creates a significant opportunity for citizens and residents of the U.S. to diversify their real estate portfolios on a tax deferred basis with property in markets distinct from the U.S. These regions have not seen the same run up in real estate values that are now tapering in some areas. The island of Guam, in particular, is experiencing record growth as development and related investment is expected to drive real estate values up considerably in the next few years.

SPLIT TREATMENT TRANSACTIONS

SPLIT TREATMENT TRANSACTIONS (ARTICLE)
USE TWO TAX CODE SECTIONS TO YOUR ADVANTAGE

ONE SALE – TWO TAX BREAKS!

A property owner selling a duplex, triplex or fourplex, where the owner lives in one unit and rents out the remaining units, can use two tax code sections and receive excellent tax advantages! The unit where the owner lives is considered their primary residence and can qualify for exclusion of capital gain taxes as descibed below under *"IRC Section 121 - Benefits of Selling a Residence."* The capital gain taxes associated with the remainder of the multi-family property can qualify for tax deferral by performing a 1031 tax deferred exchange on the rental units. All this is possible even though there is one buyer for the entire complex.

§121– BENEFITS OF SELLING A RESIDENCE

Tremendous tax benefits are available on the portion of the property considered the primary residence by the owners. The 1997 TAXPAYER RELIEF ACT provided homeowners significant tax advantages on what is considered their primary residence. Section 121 of the tax code allows a homeowner to exclude capital gain taxes if they meet the following requirements:

- Couples filing a joint tax return can exclude up to $500,000 of the capital gain on the sale of their primary residence, and single filers can exclude up to $250,000.
- The home must have been the primary residence of both spouses two of the last five years.
- This exclusion is available every two years.

§1031–BENEFITS OF EXCHANGING

Section 1031 of the Internal Revenue Code allows an owner of property "held for productive use in a trade or business" or "held for investment" to exchange for another "like-kind" property and defer paying all capital gain taxes. The units in the complex that have been rented may qualify for tax deferral benefits.

ALLOCATION ISSUES

A good accountant is generally needed to determine the value allocated to the residence portion and to the remaining units held for investment. A tax professional may use factors such as the square footage or the quality and value of improvements to each unit in determining what percentage is considered the primary residence and what percentage is allocated to the exchange portion.

EXCELLENT INVESTMENT OPPORTUNITIES

Purchasing a duplex or triplex can be an ideal first investment because the owner can live in one unit and have tenants in the other units making payments, thus helping the owner qualify for the mortgage.

REVENUE PROCEDURE 2005-14

SECTION 1. PURPOSE

This revenue procedure provides guidance on the application of § 121 and § 1031 of the Internal Revenue Code to a single exchange of property.

SECTION 2. BACKGROUND

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to $250,000 ($500,000 for certain joint returns). Under § 121(d)(6), any gain attributable to depreciation adjustments (as defined in § 1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the § 121 exclusion applies. See § 121–1(d)(1).

.02 Section 121(d), as amended by § 840 of the American Jobs Creation Act of 2004, Pub. L. 108–357, provides that, if a taxpayer acquired property in an exchange to which § 1031 applied, the § 121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property. This provision is effective for sales or exchanges after October 22, 2004.

.03 Under § 1.121–1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term "dwelling unit" has the same meaning as in § 280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.04 Section 1.121–1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method of allocating the basis and the amount realized. *Poague v. United States* , 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), *aff'd* , 947 F.2d 942 (4th Cir. 1991).

.05 Section 1031(a) 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 (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under § 1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under § 1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.06 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, § 1031(d)). See *Philadelphia Park Amusement Co. v. United States* , 126 F. Supp. 184 (Ct. Cl. 1954).

.07 Under § 1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.08 Neither § 121 nor § 1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying § 121 and another nonrecognition provision, § 1033, to a single replacement of property. Under § 1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.09 Section 121(d)(5)(B) provides that, in applying § 1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to § 121, reduced by the amount of gain excluded under § 121. Under § 121(d)(5)(B), the amount realized from an exchange of a taxpayer's principal residence for purposes of applying § 1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under § 121. Thus, Congress concluded that for exchanges meeting the requirements of both § 121 and § 1033, (1) the § 121 exclusion should be applied to gain from the exchange before the application of § 1033, (2) for purposes of determining gain that may be deferred under § 1033, the § 121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of § 121), and (3) the gain excluded under § 121 should be added in the calculation of the taxpayer's basis in the replacement property. See S. Rep. No. 830, 88th Cong., 2d Sess. 52–53, 1964–1 C.B. (Part 2) 505, 556–7 ("the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is rein-vested in the new residence"); H.R. Rep. No. 749, 88th Cong., 1st Sess. 47, 1964–1 C.B. (Part 2) 125, 171.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain on the exchange of like-kind properties under § 1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of § 1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

SECTION 4. APPLICATION

.01 *In general* . Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain from the exchange of like-kind properties under §1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 *Computation of gain* .

(1) *Application of § 121 before § 1031* . Section 121 must be applied to gain realized before applying § 1031.

(2) *Application of § 1031 to gain attributable to depreciation* . Under § 121(d)(6), the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, § 1031 may apply to such gain.

(3) *Treatment of boot* . In applying § 1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under § 121 with respect to the relinquished business property.

.03 *Computation of basis* . In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under § 121 is treated as gain recognized by the taxpayer. Thus, under § 1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under § 121.

SECTION 5. EXAMPLES

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of § 1031(a) as well as used as a principal residence as required under § 121.

Example 1 . (i) Taxpayer A buys a house for $210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of $20,000. In 2006, A exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that A intends to rent to tenants. A realizes gain of $280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§ 121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under § 121. Because the house is investment property at the time of the exchange, A may defer gain under § 1031.

(iii) Under section 4.02(1) of this revenue procedure, A applies § 121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of § 1031. A may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under § 1031. See section 4.02(2) of this revenue procedure. Although A receives $10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows.

Amount realized		$470,000
Less:	Adjusted basis	$190,000
	Realized gain	$280,000
Less:	Gain excluded under § 121	$250,000
	Gain to be deferred	$30,000

(iv) A's basis in the replacement property is $430,000, which is equal to the basis of the relinquished property at the time of the exchange ($190,000) increased by the gain excluded under § 121 ($250,000), and reduced by the cash A receives ($10,000)). See section 4.03 of this revenue procedure.

Example 2 . (i) Taxpayer B buys a property for $210,000. The property consists of two separate dwelling units (within the meaning of § 1.121–1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of $30,000 for the business use. B realizes gain of $180,000 on the exchange.

(ii) Under § 121, B may exclude gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guest-house under § 1.121–1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of $80,000 (1/3 of

$360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$100,000	$100,000	
Gain deferred under § 1031	$ 80,000		$ 80,000

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under § 121 and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange ($40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000).

Example 3 . (i) Taxpayer C buys a property for $210,000. The property consists of a house that constitutes a single dwelling unit under § 1.121–1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of $30,000 for the business use. C realizes gain of $180,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies § 121 before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain ($30,000) attributable to depreciation deductions, but may defer the remaining gain of $30,000 under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$150,000	$100,000	$ 50,000
Gain deferred under § 1031	$ 30,000		$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $90,000, which is equal to C's basis in the relinquished business property at the time of the exchange ($40,000), increased by the gain excluded under § 121 attributable to the relinquished business property ($50,000). See section 4.03 of this revenue procedure.

Example 4 . (i) The facts are the same as in *Example 3* except that C also receives $10,000 of cash in the exchange and the fair market value of the replacement business property is $110,000, which is $10,000 less than the fair market value of the business portion of the relinquished property ($120,000).

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies § 121 to exclude gain before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $50,000 of the gain allocable to the business portion of the house but may not exclude the

$30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the $30,000 of gain under § 1031. Although C receives $10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$110,000 + 10,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$150,000	$100,000	$ 50,000
Gain deferred under § 1031	$ 30,000		$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $80,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the gain excluded under § 121 ($50,000), and reduced by the cash ($10,000) received. See section 4.03 of this revenue procedure.

Example 5 . (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $540,000. The fair market value of the replacement residence is $360,000, the fair market value of the replacement business property is $180,000, and C realizes gain of $360,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $220,000 allocable to the residential portion of the house (2/3 of $540,000 amount realized, or $360,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $140,000 (1/3 of $540,000 amount realized, or $180,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of $250,000. C may defer the remaining gain of $110,000 ($140,000 realized gain minus the $30,000 gain excluded under § 121), including the $30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$540,000	$360,000	$180,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$360,000	$220,000	$140,000
Gain excluded under § 121	$250,000	$220,000	$ 30,000
Gain deferred under § 1031	$110,000		$110,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($360,000). C's basis in the replacement business property is $70,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the amount of the gain excluded under § 121 ($30,000). See section 4.03 of this revenue procedure.

Example 6 . (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $750,000. The fair market value of the replacement residence is $500,000, the fair market value of the replacement business property is $250,000, and C realizes gain of $570,000 on the exchange.

(ii) The gain allocable to the residential portion is $360,000 (2/3 of $750,000 amount realized, or $500,000, minus 2/3 of $210,000 basis, or $140,000). C may exclude gain of $250,000 from gross income under § 121. C must include in income the gain of $110,000 allocable to the residential portion that exceeds the § 121(b) exclusion limitation amount.

(iii) The remaining gain of $210,000 (1/3 of $750,000 amount realized, or $250,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. C may defer the $210,000 of gain, including the $30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$750,000	$500,000	$250,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$570,000	$360,000	$210,000
Gain excluded under § 121	$250,000	$250,000	
Gain deferred under § 1031	$210,000		$210,000
Gain recognized	$110,000	$110,000	

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($500,000). C's basis in the replacement business property is $40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under § 6511 has not expired.

DRAFTING INFORMATION

The principal author of this revenue procedure is Sara Paige Shepherd of the Office of Associate Chief Counsel (In-come Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Shepherd at (202) 622–4960 (not a toll-free call).

PRIVATE LETTER RULING 200725018

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: June 22, 2007
March 15, 2007

Section 121 — One Time Exclusion of Gain from Sale of Principal Residence

Legend:

Taxpayer A =
Taxpayer B =
Residence 1 =
Residence 2 =
Residence 3 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
X =

Dear ***:

This letter is a response to your request for a ruling under section 121(c) of the Internal Revenue Code. Specifically, you have requested a ruling that the gain on the sale of Residence 2 may be excluded under the reduced maximum exclusion in section 121(c).

Facts

On Date 1, Taxpayer A purchased Residence 1. On Date 2, Taxpayer B purchased Residence 2. After the purchase of these residences, Taxpayer A and Taxpayer B met and later married on Date 3. Taxpayer A and Taxpayer B purchased Residence 3 on Date 4 shortly after their marriage. About a month later, Taxpayer A sold residence 1 on Date 5, and Taxpayer B sold Residence 2 on Date 6. Taxpayer B held Residence 2 less than two years, about X months.

Residence 1 and Residence 2 each had three bedrooms. Residence 3 has four bedrooms. Taxpayer A has three children from a previous marriage, and Taxpayer B has two children from a previous marriage. Residence 3 allows Taxpayers A and B to provide suitable bedroom arrangements for their blended family, which includes adolescent children of the opposite sex.

Law and Analysis

Section 121(a) provides that gain from the sale or exchange of property is not included in gross income if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and used the property as the taxpayer's principal residence for periods aggregating two years or more. Section 121(b)(1) states the general rule for the maximum exclusion of gain. Section 121(b)(3) provides that subsection (a) shall not apply to any sale if, during the 2-year period ending on the date of the sale, there was any other sale or exchange by the taxpayer to which subsection (a) applied. Section 121(c) provides for a reduced maximum exclusion when a taxpayer fails to satisfy the ownership and use requirements of subsection (a) if the primary reason for the sale is the occurrence of unforeseen circumstances.

The reduced maximum exclusion is computed by multiplying the applicable maximum exclusion by a fraction. The numerator of the fraction is the shortest of the following periods: (1) the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale; (2) the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale; or (3) the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

Section 1.121-3(b) of the Income Tax Regulations provides that all the facts and circumstances of a sale will determine whether the primary reason for the sale is the occurrence of unforeseen circumstances. Factors that may be relevant in determining the primary reason for a sale include the following: (1) the suitability of the property as the taxpayer's residence materially changes; (2) the circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and (3) the circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Section 1.121-3(e)(1) provides that a sale is by reason of unforeseen circumstances if the primary reason for the sale is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. Section 1.121-3(e)(3) states that the Commissioner may issue rulings addressed to specific taxpayers identifying events or situations as unforeseen circumstances with regard to those taxpayers.

In the present case, based on the facts, representations, and the relevant law, we conclude that the occurrence of unforeseen circumstances was the primary reason for the sale of Residence 2 by Taxpayer B on Date 6. When Taxpayer B purchased and began using Residence 2 as his principal residence, he had not met Taxpayer A. He met and married Taxpayer A during the period of his ownership and use of Residence 2. As a consequence of the marriage, the suitability of Residence 2 as B's principal residence materially changed. Taxpayer A and Taxpayer B needed a larger home with more bedrooms to suitably accommodate their blended family. The occurrence of Taxpayer B's marriage to Taxpayer A and the need to suitably accommodate their blended family were unforeseen circumstances. The occurrence of these unforeseen circumstances was the primary reason for the sale of Residence 2 by Taxpayer B.

Accordingly, the gain on the sale of Residence 2, which Taxpayer B owned and used as a principal residence for less than two of the preceding five years, may be excluded under the reduced maximum exclusion of gain in section 121(c).

Caveats

Except as expressly provided, we express no opinion 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 taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, we are sending a copy of this letter to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, a taxpayer filing a return electronically may satisfy this requirement by attaching a statement to the 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 the taxpayer and accompanied by a penalty of perjury statement executed by the taxpayer. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

Sincerely,

Donna Welch
Senior Technician Reviewer
Branch 4 (Income Tax & Accounting)

VACATION HOME EXCHANGES

VACATION HOME EXCHANGES (ARTICLE)

BARRY E. MOORE V. COMM., T.C. MEMO. 2007-134

Many sellers who own vacation homes want to explore the potential of performing an Internal Revenue Code (IRC) Section 1031 tax deferred exchange. See Asset Preservation's handout entitled, "Vacation Home Exchanges - Basics", for an introduction to issues involved in these types of exchanges. One Tax Court decision, Barry E. Moore v. Commissioner, T.C. Memo. 2007-134, provides a significant case concerning whether a vacation home would be considered "held for investment." The court's analysis also indicates certain tax planning strategies investors may wish to use when considering exchanging a vacation home held for investment.

LAKEFRONT PROPERTY EXCHANGED FOR LAKEFRONT PROPERTY

In Moore v. Comm., the taxpayers exchanged a lakefront vacation property with a mobile home in Lincoln County, Georgia (the Clark Hill property) for a lakefront property with a larger five bedroom and 4.5 bath house on 1.2 acres in Forsyth County, Georgia (the Lake Lanier property). The taxpayers in this case argued that both of these properties were held for investment, specifically for long-term appreciation purposes, and thus qualified for tax deferral under IRC §1031. However, based upon the taxpayer's significant personal use of the property, the court concluded that both the relinquished Clark Hill property and the replacement Lake Lanier property should be viewed as held primarily for the taxpayer's personal use and enjoyment. In reaching this conclusion, the court considered the following: (i) the taxpayers never rented or attempted to rent the property to others; (ii) the taxpayers deducted mortgage interest as a "home mortgage interest" expense rather than investment interest expense; (iii) the taxpayers did not take (and probably did not qualify for) depreciation or other tax benefits associated with an investment property under the Internal Revenue Code, including deductions for maintenance expenses.

The court accepted the taxpayer's argument that both the relinquished and replacement properties were held for appreciation but concluded that "*...the mere hope or expectation that the property may be sold at a gain cannot establish investment intent if the taxpayer uses the property as a residence. The proposition that holding a primary or secondary (e.g. vacation) residence motivated in part by an expectation that the property will appreciate in value is insufficient to justify the classification of that property as property 'held for investment' under Section 212(2) and, by analogy, Section 1031. There is no convincing evidence that the properties were held for the production of income, and there is convincing evidence that petitioners and their families used the properties as vacation retreats. The evidence overwhelmingly demonstrates that petitioners' primary purpose in acquiring both the Clark Hill and Lake Lanier properties was to enjoy the use of those properties as vacation homes, i.e. as secondary personal residences.*"

ISSUES TO CONSIDER WHEN CONTEMPLATING A VACATION HOME EXCHANGE

Has the property been shown on one or more tax returns as an investment property or property used in a trade or business, including the characterization of mortgage interest as deductible investment interest expense or business expense? Is the improved property eligible for depreciation? Is the property used substantially as a personal vacation or second home? The characterization of residential property as held primarily for investment or for use in a trade or business is often unclear and must be made with reference to the taxpayer's use of the potential exchange property. Based on recent IRS announcements, we expect to see greater scrutiny of reported tax deferred exchanges under Section 1031. Accordingly, consult your legal or tax advisor before engaging in a tax deferred exchange.

TAX COURT MEMORANDUM 2007-134

Internal Revenue Service (I.R.S.)
Tax Court Memorandum (TC Memo)
Filed: May 30, 2007

Barry E. Moore et ux. v. Commissioner; T.C. Memo. 2007-134; No. 11002-03

BARRY E. MOORE AND DEBORAH E. MOORE,
Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

UNITED STATES TAX COURT

In 1988, Ps, Georgia residents, purchased a second home (vacation home 1), also in Georgia, which the family used on weekends from mid-April to Labor Day for recreational purposes. After Ps changed their principal residence in 1995 or 1996, the lengthened commute to vacation home 1 made its continued use impractical, and, in 1999, they agreed to purchase another vacation home (vacation home 2) closer to their principal residence. In 2000, Ps disposed of vacation home 1 and acquired vacation home 2 pursuant to a series of transactions intended to qualify as a tax-free, like-kind exchange of those properties under sec. 1031, I.R.C. Prompted by the need for liquidity incident to their then-pending divorce, Ps were holding vacation home 2 for sale at the time of trial. Ps and their children used both vacation homes exclusively for recreational purposes, and Ps never rented or offered to rent either vacation home to third parties. One of Ps' motives in acquiring and holding each vacation home was the prospect of appreciation resulting in profit on the eventual sale of each property.

P wife (PW) acquired a 2-percent membership interest in a medical LLC (the LLC) upon formation of the LLC in April 1995. In July 2000, incident to the July 28, 2000, sale of all membership interests in the LLC to a third party, the three LLC members executed a written agreement describing transfers by Dr. J, who held an 88-percent membership interest in the LLC as of Dec. 31, 1995, of 10-percent membership interests to each of the other two LLC members, PW and Dr. M (who previously held a 10- percent LLC membership interest). The agreement stated that it was "effective as of" Jan. 1, 1997. In 1998, 1999, and 2000, the LLC made distributions to the three members consistent with a 68-20-12-percent apportionment of the LLC profits among Dr. J, Dr. M, and PW, respectively. Ps argue that Dr. J's transfers of 10-percent membership interests to Dr. M and PW did not occur until July 2000. R argues that the July 2000 written agreement formalized a prior oral agreement and that the effective date of those transfers was Jan. 1, 1997.

PW received both a lump-sum cash payment and a promissory note in consideration of the July 28, 2000, sale of her 12-percent LLC membership interest. On their 2000 return, Ps reported, as long-term capital gain under the installment method of accounting, the lump-sum cash payment and the sum of the first five monthly payments due under the terms of the promissory note. R argues that Ps elected out of the installment method with respect to the gain on the sale and that Ps are required to report the full amount of that gain in 2000.

1. Held: Neither vacation home 1 nor vacation home 2 was held for investment. Therefore, Ps are not entitled to treat the disposal of the former and acquisition of the latter in 2000 as a tax-free like-kind exchange under sec. 1031, I.R.C.

2. Held, further, PW owned a 12-percent membership interest in the LLC during the years in issue, 1999 and 2000.

3. Held, further, Ps did not elect out of the installment method of accounting in connection with PW's 2000 sale of her 12-percent LLC membership interest.

Vivian D. Hoard and Patti M. Richards, for petitioners.
Michael L. Scheier & Jennifer Morales, for affected person United Surgical Partners International, Inc.
Brenda M. Fitzgerald, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HALPERN, Judge: By notice of deficiency dated April 10, 2003 (the notice), respondent determined deficiencies in petitioners' Federal income tax as follows:

Year	Deficiency
1999	$96,925
2000	78,578

By the petition, petitioners assign error to respondent's deficiency determination. The parties have resolved certain issues. The remaining issues for decision are whether (1) petitioners' purported exchange of vacation properties qualifies as a tax-free "like-kind" exchange of properties under section 1031 (the section 1031 issue), (2) petitioner Deborah E. Moore (Ms. Moore) increased her membership interest in The Surgery Center of Georgia, LLC (the LLC) before the years in issue (1999 and 2000), as alleged by respondent, or in July 2000, as alleged by petitioners (the membership interest

acquisition issue), and (3) petitioners are entitled to report Ms. Moore's gain on the sale of her membership interest in the LLC under the installment method, in accordance with section 453 (the installment method reporting issue).

The notice contains certain other adjustments that are purely computational. Their resolution solely depends upon our resolution of the issues remaining in dispute.

Petitioners' Challenge to Respondent's Briefs

On the basis of Rule 151(b), Time for Filing Briefs, petitioners argue that we must disregard respondent's opening brief because respondent filed that brief 1 day late and did not move before the due date for an extension of time to file. Petitioners also argue that, because respondent "failed to file" an opening brief and did not seek leave of the Court to file a reply brief, he is not permitted to file a reply brief. See Rule 151(b).

Petitioners argue that respondent should have filed his opening brief no later than August 15, 2005, the last day of the 60-day period allotted by the Court for such filings at the conclusion of the trial on June 15, 2005, even though the trial transcript furnished to the parties records both the trial clerk and the Court as stating that due date to be August 16, 2005, the date upon which respondent's opening brief was actually filed.

Because the Court identified a due date one day after the close of the 60-day period allocated by the Court for the filing of opening briefs, the Court must accept some responsibility for the tardiness, if any, in respondent's filing of his opening brief. Moreover, 1 day is negligible, and we do not believe that it prejudiced petitioners in preparing their answering brief. In fact, petitioners do not allege that they were so prejudiced; they allege only that we "must strike and disregard" respondent's brief pursuant to Rule 151. Under the circumstances, we find it inappropriate to disregard or strike respondent's opening (or reply) brief, and we decline to do so.

FINDINGS OF FACT

Some facts have been stipulated and are so found. The stipulation of facts, with attached exhibits, is incorporated herein by this reference.

At the time the petition was filed, petitioner Barry E. Moore (Mr. Moore) resided in Elberton, Georgia, and Ms. Moore resided in Marietta, Georgia.

The Section 1031 Issue

Background

On April 15, 1988, petitioners purchased two contiguous parcels of lakefront real property, along with a mobile home located on one of those parcels, on Clark Hill Lake in Lincoln County, Georgia (the Clark Hill property). On December 3, 1999, petitioners entered into a purchase and sale agreement wherein they agreed to purchase improved lakefront property in Forsyth County, Georgia (the Lake Lanier property). Thereafter, during 2000, petitioners were involved in a series of transactions whereby they purported to (1) assign a 25-percent interest in the purchase and sale agreement to an escrow agent, (2) join with the escrow agent in purchasing the Lake Lanier property (75 percent acquired by petitioners, 25 percent by the escrow agent), and (3) after buyers for the Clark Hill property had been found, through an intermediary, exchange the Clark Hill property for the escrow agent's 25-percent interest in the Lake Lanier property in a transaction intended to qualify as a deferred like-kind exchange satisfying the requirements of section 1031(a)(3) and section 1.1031(k)-1, Income Tax Regs. Respondent denies the authenticity of much of petitioners' supporting documentation and alleges that (1) the escrow agent was, in substance, acting as petitioners' agent in acquiring a 25-percent interest in the Lake Lanier property so that petitioners already owned that property before the purported like-kind exchange; i.e., there was no "exchange" of like-kind properties, and (2) petitioners otherwise failed to satisfy the requirements of section 1031(a)(3) and the regulations thereunder for a deferred like-kind exchange.

In order for petitioners to prevail on the section 1031 issue, the evidence must show that (1) the Clark Hill and Lake Lanier properties were of like kind (a matter not in dispute), (2) petitioners held both properties for investment,4 and (3) they disposed of the former and acquired the latter in a manner that satisfied the requirements of section 1031(a)(3) and the regulations thereunder for a deferred like-kind exchange. Because we find that petitioners held neither property for investment, we make no findings of fact relating to the sufficiency of petitioners' attempt to satisfy the other requirements for a deferred like-kind exchange.

Petitioners' Purchase and Use of the Properties

The Clark Hill Property

Petitioners' decision to purchase the Clark Hill property was motivated, in part, by their familiarity with the area, both having grown up in the vicinity of Clark Hill Lake. In addition, both their families owned property on or near Clark Hill, and Mr. Moore's father advised them that property on Clark Hill Lake had appreciated and would continue to appreciate. Petitioners' decision to invest in real estate rather than in intangibles, such as stocks or bonds, was influenced by a prior bad experience with a financial adviser who had stolen their money.

When in 1988 they purchased the Clark Hill property, petitioners' primary residence was in Norcross, Georgia, an approximately 3-hour drive from the Clark Hill property. In 1995 or 1996, petitioners changed their primary residence to Marietta, Georgia. The drive from the Marietta residence to the Clark Hill property normally took between 5 and 6 hours.

Beginning in late March of each year during which they owned the Clark Hill property, Mr. Moore would spend a couple of weekends there getting it ready for the summer months. Then, beginning in mid to late April, petitioners' family would visit the property two and, sometimes, three weekends a

month until Labor Day, when Mr. Moore closed the property for the winter. Between Labor Day and the following March, Mr. Moore would occasionally visit the property to rake leaves and perform other caretaker functions.

The mobile home located on the property was a double-wide mobile home. During their tenure, petitioners built a deck around it, built a screened-in porch on top of a portion of the deck, and installed a satellite television receiver, a new television, and a VHS recorder. They also replaced the roof and repainted the home two or three times. They installed a new washer and dryer and replaced some of the furniture (bedroom seats and beds) that had come with the home. They kept a pontoon boat on Clark Hill Lake and improved the dock they had in the lake to conform to the U.S. Army Corps of Engineers electrical requirements. During their summer stays at the Clark Hill property, petitioners and their children used the property for various recreational purposes, including relaxing on the dock, boating, and fishing.

Until they decided to acquire the Lake Lanier property in late 1999, petitioners had never advertised the Clark Hill property for sale although they had been offered money for it. Also, petitioners never rented or attempted to rent the property to others.

On their 1996-99 Federal income tax returns, petitioners listed deductions for "home mortgage interest". They did not list on those returns any deduction for investment interest, nor did they deduct any maintenance or other expenses associated with the Clark Hill property.

The Lake Lanier Property

Reasons for Purchase

After petitioners changed their principal residence from Norcross to Marietta, Georgia, the length of the drive to the Clark Hill property coupled with their children's increased weekend activities (in particular, their son's participation in weekend sports) made it inconvenient for the family to spend weekends at the property. As a result, they used that property less frequently and, during the 2 years before their disposition of it, they may have visited the property a total of three times. During that period, it became a chore for Mr. Moore just to maintain the property, with the result that it became rundown and had to be either renovated or disposed of.

Beginning in late 1997 or early 1998, the foregoing problems associated with the Clark Hill property caused petitioners to investigate properties on Lake Lanier, which is much closer to what was at the time petitioners' Marietta, Georgia, residence. Petitioners felt that a house on Lake Lanier would be of more use to them than the Clark Hill property. Petitioners also believed that property on Lake Lanier would appreciate more rapidly than the Clark Hill property because it was closer to the metropolitan Atlanta area. Petitioners acquired the Lake Lanier property in January 2000.

Use of the Property

The Lake Lanier property consisted of a greater than 1.2 acre tract of land, the largest double slip dock allowable on the lake (complete with two lifts), and a house that had five screened-in porches overlooking the lake, a full party deck, a covered veranda, a great room with a stone fireplace, five bedrooms, and 4-1/2 bathrooms. At the time of purchase, the house was partially furnished, and, after purchase, petitioners completed the furnishing themselves. They installed a satellite TV system and a VHS recorder, and, before their second summer at the property, they purchased a motorboat with room for six to eight passengers.

Petitioners and their children engaged in essentially the same activities at the Lake Lanier property as they had at the Clark Hill property. They visited the property two weekends per month beginning in mid-March (depending on the weather) and ending around Labor Day. In addition, the family might visit the property once or twice each winter, and Mr. Moore and his son would fish off the dock one Saturday night each month during the fall. During the summer months, petitioners occasionally entertained visitors at the house. Mr. Moore's maintenance activities at the Lake Lanier property were similar to, but less frequent than, his maintenance activities at the Clark Hill property.

The mortgage lender in connection with petitioners' purchase of the Lake Lanier property was SouthTrust Bank, N.A. (SouthTrust Bank).6 On their 2000-02 Federal income tax returns, petitioners claimed deductions for home mortgage and investment interest paid to SouthTrust Bank as follows:

Year	Home Mortgage Interest	Investment Interest
2000	$36,219	$5,647
2001	42,437	1,994
2002	45,766	--

As in the case of the Clark Hill property, petitioners did not list on their 2000-02 returns any deductions for maintenance or other expenses associated with the Lake Lanier property. Also, as in the case of the Clark Hill property, petitioners never rented or attempted to rent the Lake Lanier property, and they never offered it for sale until forced to do so by the need for liquidity in connection with the division of their assets incident to their divorce. Both the sale and the divorce were still pending at the time of the trial.

The Membership Interest Acquisition Issue

The LLC Operating Agreement

The LLC was organized in the State of Georgia on April 19, 1995, and, as of that date, the "Operating Agreement of The Surgery Center of Georgia" (the LLC operating agreement or the agreement) became effective. Pursuant to the agreement, the initial members of the LLC and their initial membership interests were as follows:

Member	Percent Interest
Laser Centers of America, Inc.	45
Stephen N. Joffe, M.D.	35
Barry McKernan, M.D.	10
Hugh McLeod, M.D.	8
Deborah Moore	2

At that time, Dr. Joffe was the CEO and sole shareholder of Laser Centers of America, Inc., which was designated the manager of the LLC.

Article 8 of the LLC operating agreement governs "Allocations and Distributions". Section 8.5, entitled "Interim Distributions", provides in pertinent part as follows:

To the extent * * * [cash in excess of current and anticipated needs] exists, the Members * * * may make Distributions to the Members in accordance with their Membership Interests. Such distributions shall be in cash or Property (which need not be distributed proportionately) or partly in both, as determined by the Manager.

Article 10 of the agreement is entitled "Disposition of Membership Interests". Section 10.1 provides: "No Membership Interest of the * * * [LLC] shall be Disposed, except as hereinafter provided in this Article 10." Section 10.2.1, governing voluntary dispositions of membership interests, provides in pertinent part: "Any Member who desires voluntarily to Dispose of the Membership Interest * * * owned by him in the * * * [LLC] shall give the Manager * * * written notice of his intent and the terms of such proposed Disposition." Section 10.3 gives the LLC an overall 90-day right of first refusal to purchase or to designate a purchaser for the selling member's interest at a designated purchase price. Section 10.5 provides that the closing of a sale of a membership interest must occur no later [earlier?] than 90 days after the giving of written notice of the sale required in section 10.2. Section 10.7 states: "Any attempted Disposition of a Membership Interest, or any part thereof, not in compliance with * * * [article 10] is null and void ab initio."

Dr. Joffe's 1995 Purchases of Additional Interests in the LLC

On September 28, 1995, Laser Centers of America, Inc., sold its 45-percent membership interest in the LLC to Dr. Joffe, and, on December 31, 1995, Dr. McLeod sold his 8-percent membership interest in the LLC to him. As a result, as of December 31, 1995, Dr. Joffe owned 88 percent, Dr. McKernan owned 10 percent, and Ms. Moore owned 2 percent of the LLC.

The Moore Letter; the Joffe Memorandum

In a handwritten letter dated July 1, 1997, to James P. Kelly (Mr. Kelly), counsel to the LLC during 1996-98, Ms. Moore listed percentage distributions, including an 8-percent share for herself, "should * * * [the LLC] be sold or distributions be made." In that letter (the Moore letter), Ms. Moore further noted: "Deborah Moore has 2% originally already. Also, the agreement for the above percentages in no way interferes with the original LLC percentages."

Sometime between July 1 and late December 1997, Dr. Joffe executed a handwritten, undated memorandum (the Joffe memorandum) to Ms. Moore, in which he states: "This is to confirm that Debbie Moore will receive 10% (Ten Percent) of the net proceeds of the sale of * * * [the LLC]."

The Kelly Correspondence

During 1997, Mr. Kelly sent three letters (the Kelly correspondence) to Ms. Moore in her capacity as the de facto manager of the LLC.

In the first letter, dated October 17, 1997, Mr. Kelly advised Ms. Moore that the LLC could "lawfully issue 6% of its stock to you under the safe harbor for reasonable compensation to employees." The letter also describes the formal requirements needed to effect such an issuance of shares.

The other two letters, both dated October 28, 1997, concern the potential application of Medicare Antikickback laws to proposed physician acquisitions of stock in the LLC. In one of those letters, Mr. Kelly states his understanding that the LLC "currently is owned by Dr. Joffe (88%) * * * Dr. McKernan (10%) and * * * [Ms. Moore] (2%)".

The SouthTrust Bank Credit Offering Report and the $50,000 Revolving Note

In connection with a $50,000 loan to the LLC, evidenced by a $50,000 "revolving note" dated March 29, 1999, SouthTrust Bank prepared a "Credit Offering Report" (the SouthTrust Bank credit report), which states: "The [LLC] was started, according to the tax return, on 5/1/95. During 1995, two members of the LLC sold their interests to Dr. Joffe who now owns 88%." That portion of the SouthTrust Bank credit report is date-stamped "Dec-01-98". In another portion of the SouthTrust Bank credit report, entitled "Collateral", the word "Unsecured" appears. The word "Unsecured" is also typed on the revolving note in the section of the printed form dealing with security agreements.

The LLC Returns

The initial short year return, Form 1065, U.S. Partnership Return of Income, filed by the LLC for 1995 reflects the 1995 sales by Laser Centers of America, Inc., of its 45-percent ownership interest and by Dr. McLeod of his 8-percent ownership interest in the LLC to Dr. Joffe. The sales are reflected in footnotes to the Schedules K-1, Partner's Share of Income Credits, Deductions, etc., prepared for Drs. Joffe and McLeod and for Laser Centers of America, Inc.

The returns filed by the LLC for 1996-99 include Schedules K-1 for Drs. Joffe and McKernan and for Ms. Moore (collectively, the LLC members), which reflect percentage profit and loss sharing and capital ownership interests for them of 88, 10, and 2 percent, respectively. The LLC's final return for its short year ending July 31, 2000, reflects those same percentage interests for the LLC members at the beginning of the year, and a zero-percent interest for each at yearend.

The LLC's 1996 and 1997 returns reflect no distributions to the LLC members. The 1998-2000 LLC returns reflect distributions to the LLC members in the following amounts and percentages of total distributions:

	1998		1999		2000	
Member	Amount	% of Total	Amount	% of Total	Amount	% of Total
Dr. Joffe	$40,538	67.86	$268,510	63.91	$978,466	68
Dr. McKernan	12,000	20.08	96,979	23.08	287,785	20
Ms. Moore	7,200	12.05	54,642	13.01	172,671	12

Sale of the LLC Membership Interests

On or about November 30, 1999, the LLC, the LLC members, and Surgicoe Corp. (Surgicoe) entered into a "Membership Interest Purchase Agreement" (the Surgicoe purchase agreement) pursuant to which the LLC members agreed to sell their membership interests in the LLC to Surgicoe for a total of $9,988,352, subject to certain adjustments at closing. After those adjustments, the total purchase price was reduced to $9,490,051. The Surgicoe purchase agreement provides that "[t]he Purchase Price shall be allocated as set forth in Schedule 2.2.4." The record contains two such schedules. The first, presumably attached to the agreement, provides: "Consideration to be allocated among Sellers as provided in a closing statement to be executed by Sellers at Closing." The second, presumably executed sometime between the dates of the Surgicoe purchase agreement and the closing, allocates the total purchase price among the LLC members on the following percentage basis: 68 percent to Dr. Joffe, 20 percent to Dr. McKernan, and 12 percent to Ms. Moore. The distribution of the final, adjusted purchase price was as follows:

Member	Amount	% of Total
Dr. Joffe	$6,453,234.68	68
Dr. McKernan	1,898,010.20	20
Ms. Moore	1,138,806.12	12

Surgicoe's purchase of Ms. Moore's interest in the LLC consisted of Ms. Moore's receipt from Surgicoe of $661,774.01 in cash, LLC debt relief apportioned to Ms. Moore of $316,206.24, and a promissory note dated July 28, 2000, in the sum of $160,825.87. Also, on that date, Ms. Moore executed (1) a "Certificate of Limited Liability Company Interest in the Surgery Center of Georgia, LLC", in which she certifies to her ownership of a "12% limited liability company interest * * * in [the LLC]," and (2) an "Irrevocable Member Interest Power" pursuant to which she states that she "does hereby sell * * * to [Surgicoe] a 12% interest as a member in [the LLC]" and appoints a named attorney to transfer that interest on the LLC's books.

Assignment and Assumption Agreement

In 2000, in connection with, and sometime before, the July 28, 2000, closing of the sale of the LLC membership interests to Surgicoe, Drs. Joffe and McKernan and Ms. Moore executed an "Assignment and Assumption Agreement * * * made and entered into and effective as of the 1st day of January, 1997" (the assignment and assumption agreement or, sometimes, just the agreement), whereby Dr. Joffe, "in consideration of the continued services of * * * [Dr. McKernan and Ms. Moore] and other good and valuable consideration", transferred a 10-percent membership interest in the LLC to Dr. McKernan and a 10-percent membership interest in the LLC to Ms. Moore. The last sentence of the agreement, just before the signatures of Drs. Joffe and McKernan and Ms. Moore, reads: "IN WITNESS WHEREOF, the parties have executed this Agreement under seal to be effective as of the date [January 1, 1997] first above written." The agreement states that it is "a Georgia contract and shall be governed by and construed in accordance with Georgia law."

Dr. Joffe, on behalf of himself as manager of the LLC and on behalf of the LLC, executed a "Waiver of Notice and Right to Purchase" (which is attached to the assignment and assumption agreement) whereby he specifically waived (1) the right to receive notice pursuant to section 10.2.1 of the LLC operating agreement of his membership interest dispositions and (2) the LLC's rights, pursuant to section 10.3 of the LLC operating agreement, either to purchase Dr. Joffe's 10-percent membership interests transferred to Dr. McKernan and Ms. Moore or to identify another purchaser thereof.
The Installment Method Reporting Issue

As noted supra, part of the consideration Ms. Moore received for the sale of a 12-percent interest in the LLC to Surgicoe consisted of a promissory note in the sum of $160,825.87. That note provided for 60 consecutive monthly payments of combined principal and interest of $3,358.03, beginning September 1, 2000, and ending August 1, 2005. On their 2000 return, Schedule D, Capital Gains and Losses, petitioners reported as long-term capital gain $631,590 from the July 28, 2000, sale of "partnership interest" and "note payments" in the sum of $16,790.

OPINION

I. The Section 1031 Issue

A. Analysis

As noted supra, the issue before us is whether petitioners held the Clark Hill and Lake Lanier properties "for investment". That depends on their intent or purpose in holding the properties, determined as of the time of the exchange. E.g., Bolker v. Commissioner, 81 T.C. 782, 804 (1983), affd. 760 F.2d 1039 (9th Cir. 1985).

Petitioners point to their interest in the appreciation potential of the Clark Hill and Lake Lanier properties, both before and after acquisition, and argue: "If investment intent is one motive for holding * * * property, it is held for investment for purposes of Section 1031." Petitioners' argument, if carried to its logical extreme, is that the existence of any investment motive in holding a personal residence, no matter how minor a factor in the overall decision to acquire and hold (or simply to hold) the property before its inclusion in an exchange of properties, will render it "property * * * held for investment" with any gain on the exchange eligible for nonrecognition treatment under section 1031.

Petitioners are mistaken.

It is a taxpayer's primary purpose in holding the properties that counts. Montgomery v. Commissioner, T.C. Memo. 1997-279 ("section 1031 requires that both the property transferred and the property received in a like-kind exchange be held primarily for productive use in a trade or business, or for investment."), affd. in part and revd. in part on another issue without published opinion 300 F.3d 866 (10th Cir. 1999). Indeed, in Starker v. United States, 602 F.2d 1341, 1350-1351 (9th Cir. 1979), the U.S. Court of Appeals for the Ninth Circuit recognized the longstanding rule that the exclusive use of property by the owner as his residence contradicts any claim by him that the property is held for investment. The court applied the rule specifically to section 1031 exchanges. The court said:

It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment. Losses on the sale or exchange of such property cannot be deducted for this reason, despite the general rule that losses from transactions involving * * * investment properties are deductible. A similar rule must obtain in construing the term "held for investment" in section 1031. * * * [Id.; citations omitted.]

This and other courts have reached the same conclusion in the context of deciding whether expenses incurred with respect to a personal residence are deductible under section 212(2) as "expenses paid or incurred * * * for the management, conservation, or maintenance of property held for the production of income". Property held for investment is property held for the production of income within the meaning of section 212. See Newcombe v. Commissioner, 54 T.C. 1298, 1302 (1970) (an expense deduction is justified under section 212(2) only if the property to which it relates "is 'held for investment,' i.e., for the production of income"); sec. 1.212-1(b), Income Tax Regs. Thus, both section 1031 and section 212(2) involve the same factual inquiry whether the property in question was held for investment.

As a preliminary matter, we accept as a fact that petitioners hoped that both the Clark Hill and Lake Lanier properties would appreciate. However, the mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence. See Jasionowski v. Commissioner, 66 T.C. 312, 323 (1976) ("if the anticipation of eventually selling the house at a profit were in itself sufficient to establish that the property was held with a profit-making intent, rare indeed would be the homeowner who purchased a home several years ago who could not make the same claim"). Moreover, a taxpayer cannot escape the residential status of property merely by moving out. In Newcombe v. Commissioner, supra, the taxpayers listed their former residence for sale on or about the day they moved out, December 1, 1965. They sold the property at a loss on February 1, 1967. The issue in Newcombe relevant to this case was whether, during 1966, the property was held for the production of income (i.e., for investment) so as to entitle the taxpayers to deductions for maintenance expenses under section 212(2). In denying those deductions we stated:

The taxpayer must * * * be seeking to realize a profit representing postconversion appreciation in the market value of the property. Clearly, where the profit represents only the appreciation which took place during the period of occupancy as a personal residence, it cannot be said that the property was "held for the production of income." * * * [Id. at 1302.]

We added: "The placing of the property on the market for immediate sale, at or shortly after * * * its abandonment as a residence, will ordinarily be strong evidence that a taxpayer is not holding the property for postconversion appreciation in value." Id.10

This Court has frequently applied the reasoning of one or both of Jasionowski and Newcombe in rejecting taxpayer arguments that because a second or vacation home was held for appreciation (i.e., investment) the taxpayer was entitled to a deduction, under section 212(2), for expenses incurred to maintain or improve the property. See, e.g., Ray v. Commissioner, T.C. Memo. 1989-628; Houle v. Commissioner, T.C. Memo. 1985-389; Gettler v.

Commissioner, T.C. Memo. 1975-87. In both Ray and Houle we denied the deductions on the ground that the taxpayers treated the houses as a "second home" (Ray) or "second residence" (Houle). In Gettler, we denied the deductions, concluding that "the primary purpose in both acquiring the house and holding on to it was to use it as a vacation home." The cited cases stand for the proposition that the holding of a primary or secondary (e.g., vacation) residence motivated in part by an expectation that the property will appreciate in value is insufficient to justify the classification of that property as property "held for investment" under section 212(2) and, by analogy, section 1031.

Moreover, putting aside petitioners' expectations that both the Clark Hill and Lake Lanier properties would appreciate in value, there is no convincing evidence that the properties were held for the production of income, and there is convincing evidence that petitioners and their families used the properties as vacation retreats. Petitioners made neither the Clark Hill nor Lake Lanier property available for rent. Nor is there any evidence that petitioners held either property primarily for sale at a profit. They did not offer the Clark Hill property for sale until late 1999 when they decided to acquire the more accessible Lake Lanier property. Thereafter, the Clark Hill property was held for immediate sale, not for investment. See Newcombe v. Commissioner, supra at 1302. They did not offer the Lake Lanier property for sale until required to do so by the need for liquidity incident to their divorce. While it is true that Mr. Moore spent considerable time fixing up and maintaining both properties and petitioners made substantial improvements at the Clark Hill property, those actions are consistent with enjoying the properties as vacation homes. Petitioners did not hold the Clark Hill property out for rent or sale, yet they added a deck and screened-in porch, installed a satellite television receiver, and purchased a television, a VHS recorder, and a new washer and dryer for their use at the property. They replaced furniture and kept a boat on the lake, which they used for boating and fishing. Petitioners added similar electronic equipment to the Lake Lanier house. That house was of some substance, containing five bedrooms and having, among other amenities, five screened-in porches overlooking the lake, a double slip dock, a great room with a stone fireplace, and a full party deck. Surely, that house represented a substantial portion of the purchase price of the Lake Lanier property, yet petitioners made no effort to recover any portion of that investment by renting the house out; indeed, they did not even offer it for rent. Petitioners would have us believe that they used the house only as a caretaker's cottage while awaiting the expected appreciation in the value of the property as a whole. While awaiting that event, however, they purchased a 6-to 8-passenger motorboat to pass the time on the lake. Also inconsistent with their claim that they held the two properties for investment is their failure to claim any tax deductions for maintenance expenses or depreciation connected with the properties. Also, on their tax returns, they treated all of their interest deductions for 1996-99 and most of those deductions for 2000-02 as home mortgage interest rather than as investment interest.

In short, the evidence overwhelmingly demonstrates that petitioners' primary purpose in acquiring and holding both the Clark Hill and Lake Lanier properties was to enjoy the use of those properties as vacation homes; i.e., as secondary, personal residences. That conclusion is buttressed by Mr. Moore's testimony that, after petitioners' regular weekend use of the Clark Hill property ceased during the last 2 years of their ownership, they allowed it to become "run down" so that it "needed to be looked after or * * * [disposed of]." That lack of upkeep is inconsistent with a professed intention to protect their investment in and maximize their profit on the sale of the property but consistent with an attitude that continued upkeep and maintenance were warranted only in connection with petitioners' regular, personal use of the property.

The caselaw upon which petitioners principally rely is inapposite. In Vandeyacht v. Commissioner, T.C. Memo. 1994-148, we sustained the taxpayers' deductions for expenses associated with two oceanfront recreational properties. In that case, however, the taxpayers never occupied the properties, a condominium and a house, nor used them for personal purposes; and, although the taxpayers' children and friends stayed in both properties, they paid fair market rent to the taxpayers.

In Hambleton v. Commissioner, T.C. Memo. 1982-234, we denied deductions for expenses relating to farming activities on a 110acre tract of farmland because we found that the taxpayers lacked the requisite profit motive under section 183. We found, however: "Although * * * [the taxpayers] used approximately one acre surrounding the house for personal use, * * * [the taxpayers'] principal motivation in purchasing the 110 acre farm was to realize a profit through appreciation in the value of the land." We denied the deductions only because the taxpayers were unable to explain how any of the expenses were "ordinary and necessary to the holding of the property as an investment." The taxpayers' circumstances in Hambleton are readily distinguishable from petitioners' circumstances wherein the properties in question are not obviously divisible into residential and nonresidential portions and, as far as we can tell, were used entirely and exclusively as weekend vacation retreats.

Lastly, neither Holmes v. Commissioner, 184 F.3d 536 (6th Cir. 1999), revg., vacating, and remanding T.C. Memo. 1997-401, nor Frazier v. Commissioner, T.C. Memo. 1985-61, addresses the issue of whether a personal residence that the taxpayers use exclusively for recreational purposes can constitute property held for investment. Rather, the issue in both cases, decided in the taxpayers' favor, was whether incidental recreational or residential use by the taxpayers or family members of property primarily used by the taxpayers for commercial farming or fishing (or whether the personal enjoyment they derived from those primary usage activities) negated the taxpayers' profit motive for engaging in those activities.

B. Conclusion

Neither the Clark Hill nor Lake Lanier property constituted property held for investment for purposes of section 1031(a). Therefore, petitioners' disposition of the former and acquisition of the latter did not qualify as a tax-free "like-kind" exchange of properties under section 1031.
II. The Membership Interest Acquisition Issue

A. Introduction

Our resolution of this issue will determine whether petitioners are required to report, as Ms. Moore's distributable share, 2 percent of the LLC's income for the years in issue, as alleged by petitioners, or 12 percent of that income, as alleged by respondent.

B. Petitioners' Position

Petitioners acknowledge that Dr. Joffe transferred a 10percent membership interest in the LLC to Ms. Moore, which, together with his transfer of another 10-percent interest to Dr. McKernan, reduced his percentage membership interest in the LLC from 88 to 68 percent and increased Ms.

Moore's percentage membership interest from 2 to 12 percent. Petitioners argue, however, that those transfers occurred in July 2000 upon the execution of the assignment and assumption agreement.
Petitioners also argue that the 1998-2000 distributions from the LLC to its members in amounts either precisely or closely reflecting a 68-20-12-percent profit split among Dr. Joffe, Dr. McKernan, and Ms. Moore, respectively (referred to by petitioners' counsel, on brief, as "disproportionate distributions"), did not reflect a shift in the membership interests among those three individuals before July 2000, but, instead, reflected an informal agreement among them that Dr. McKernan and Ms. Moore should be compensated by those distributions for the use of LLC profits and the pledge of LLC assets to discharge Dr. Joffe's debt to the creditors of his failed surgery center in Cincinnati, Ohio. In effect, petitioners argue that, to the extent the 1998-2000 distributions to Ms. Moore and Dr. McKernan exceeded 2 percent and 10 percent, respectively, of the LLC's current and accumulated profits, they represented a return of capital.

In support of their position, petitioners rely primarily upon: (1) the Moore letter, which speaks of distribution percentages and not shares of income, (2) the Joffe memorandum, confirming his agreement to give Ms. Moore "10% of the net proceeds upon the sale of * * * [the LLC]", but, petitioners argue, not an additional 10-percent share of annual income, (3) the fact that the Schedules K-1 attached to the 1997-2000 LLC partnership returns all state that the three members share LLC profits and losses in a ratio of 88 percent for Dr. Joffe, 10 percent for Dr. McKernan, and 2 percent for Ms. Moore, (4) the Kelly correspondence, in which Mr. Kelly expressed his understanding, presumably obtained from the Moore letter and, perhaps, from other conversations or communications with Ms. Moore, that the foregoing 88-10-2-percent LLC ownership split was still in effect, (5) the LLC members' failure to satisfy the requirements of the LLC operating agreement governing dispositions of membership interests, and (6) the SouthTrust Bank credit report, which, petitioners allege, indicates that, as late as December 1, 1998, SouthTrust Bank believed that Dr. Joffe still owned 88 percent of the LLC. Petitioners state: "The documentary evidence of the bank loan * * * confirms that * * * [Dr. Joffe] pledged * * * [his 88 percent] membership interest to SouthTrust Bank in March 1999, [the date of the loan] over two years after respondent claims he transferred 10% of that interest [to Ms. Moore]."

Petitioners view the language in the assignment and assumption agreement creating an effective date "as of" January 1, 1997, (the effective date provision) as an improper and ineffective "backdating" of that agreement or, alternatively, as "a draftsman's error that can be reformed under Georgia law"; i.e., as a mutual mistake correctable by the introduction of parol evidence.

C. Respondent's Position

Respondent argues that the assignment and assumption agreement was the means of "formalizing" Dr. Joffe's transfer of 10-percent membership interests in the LLC to Dr. McKernan and Ms. Moore effective January 1, 1997, and that "[f]rom that time forward" the division of ownership among the LLC members was 68 percent for Dr. Joffe, 20 percent for Dr. McKernan, and 12 percent for Ms. Moore. In support of his position, respondent argues that the 1998-2000 cash distributions to those three individuals "in the approximate ratio of 68/20/12 * * * demonstrates that the LLC made its cash distributions based upon the members' interests, as modified in 1997."

Respondent also seeks to refute all of petitioners' attacks on the effective date provision. He acknowledges the failure to follow the procedural requirements set forth in the LLC operating agreement for transfers of membership interests, but he points out that those requirements were specifically waived by Dr. Joffe, as manager of the LLC, and by the parties to the assignment and assumption agreement by their entering into that agreement, an action that amounted to their consent to the waiver of those requirements. He argues that the assignment and assumption agreement was not "backdated", i.e., it "was not a document * * * [attempting] to change the past or * * * to misrepresent the past", but, rather, "was * * * created to formalize informal transactions that had occurred in the past". He also argues that the effective date provision is not an example of mutual mistake that would otherwise permit petitioners to introduce parol evidence to establish the actual effective date of Dr. Joffe's transfer of a 10-percent interest in the LLC to Ms. Moore; and he argues that the LLC's 1998-2000 increased distributions to Dr. McKernan and Ms. Moore were not simply a monetary quid pro quo for the use of LLC assets as collateral for the discharge of Dr. Joffe's bank debt related to his failed Cincinnati Surgery Center. Rather, he argues that those distributions corroborated a prior increase in the LLC membership interests of those individuals.

D. Analysis

1. Introduction

Although each party can point to evidence supporting that party's view regarding the date upon which Ms. Moore's membership interest in the LLC increased from 2 percent to 12 percent, we find that a preponderance of the evidence supports respondent's view that Ms. Moore owned a 12-percent membership interest in the LLC during the years in issue, 1999 and 2000.

2. The Assignment and Assumption Agreement

The assignment and assumption agreement does not set forth an execution date. Rather, it states that it "is made and entered into and effective as of the 1st day of January, 1997 by and among * * * [the LLC members]".

Petitioners argue that the execution date of the agreement (alleged by petitioners, without dispute by respondent, to be sometime during July 2000, when the agreement was entered into in connection with the closing of the sale of the membership interests in the LLC to Surgicoe) is its effective date. They cite Georgia caselaw, which permits the introduction of parol evidence to establish the actual date of execution, and they rely upon both Georgia statutory law and caselaw, which permit equitable reformation of a contract in order to conform with the true intent of the parties where there has been a mutual mistake in the drafting of the contract. Respondent disputes the applicability of both lines of authority.

a. Enforceability of the Effective Date Provision

(1) Governing Principles of Georgia Law

As noted supra, the assignment and assumption agreement specifically states that it is to be "governed by and construed in accordance with Georgia law." Under Georgia law, it is clear that the parties to a contract can give the contract retroactive effect. See Am. Cyanamid Co. v. Ring, 286 S.E.2d 1, 3 (Ga. 1982). In that case, the Supreme Court of Georgia was called upon to determine the effective date of a contract executed by the parties sometime after July 1, 1975, the first sentence of which read: "This contract entered into as of July 1, 1975", and the last sentence of which read: "In witness whereof, the parties hereto have executed this contract as of the day and year first above written." On the basis of those two sentences (which are virtually identical, both in language and in contract placement, to the corresponding sentences in the assignment and assumption agreement), the court held that the effective date of the contract was July 1, 1975. In reaching that conclusion, the court observed that "the effective date of a contract is not the date of execution where the contract expressly states that its terms are to take effect at an earlier date." Id. at 674; see also Goldstein v. Ipswich Hosiery Co., 122 S.E.2d 339, 345 (Ga. Ct. App. 1961) ("It is elemental that contracting parties may agree to give retroactive effect, between themselves, to their contracts as they may see fit."); 2 Williston on Contracts, sec. 6:60 (4th ed. 1991) ("it seems clear that, where the parties themselves agree that a contract between them should be given effect as of a specified date, absent the intervention of third party rights, there is no sound reason why that agreement should not be given effect"). Williston cites both Am. Cyanamid and Goldstein as the embodiment of Georgia precedent in support of the quoted statement.

Petitioners attempt to discredit the effective date language of the agreement, alleging that it is inconsistent with Dr. Joffe's and Ms. Moore's actions during 1997-2000, which, they argue, demonstrate an intent to transfer a 10-percent membership interest in the LLC from Dr. Joffe to Ms. Moore no earlier than July 2000. Under Georgia law, however: "Where the terms of a written contract are clear and unambiguous, the court will look to the contract alone to find the intention of the parties." Health Serv. Ctrs., Inc. v. Boddy, 359 S.E.2d 659, 661 (Ga. 1987).

(2) The Effective Date Provision Is Not a Prohibited Backdating of the Assignment and Assumption Agreement

We do not view the effective date provision as an attempt to backdate the assignment and assumption agreement in order to retroactively obtain an unwarranted tax benefit. Rather, we consider its purpose to have been to reduce to writing a prior oral understanding among the parties. As the cases petitioners cite make clear, "backdating" generally involves an effort to make it appear that the document in question was executed on a date prior to its actual execution date; i.e., there is an effort to mislead the reader. That is not true of the assignment and assumption agreement, where the "effective as of" phrase makes clear that the intended effective date differs from the execution date.

The parties to the agreement were operating at arm's length. A retroactive increase in Dr. McKernan's and Ms. Moore's share of LLC profits would have necessarily resulted in a retroactive decrease in Dr. Joffe's share of those profits. Thus, aside from possible tax rate differentials among the three individuals (unsupported by any evidence in the record), the respondent is indifferent as regards the respective profit shares of each. The cases petitioners cite do not involve parties dealing at arm's length or IRS indifference to their actions. In Georgiou v. Commissioner, T.C. Memo. 1995-546, we rejected taxpayer attempts to rely upon (1) documents dated 1 to 3 years before their actual execution dates in order to establish beneficial stock ownership, during the preexecution years, of a corporation the losses of which would then have been available in consolidation to offset the taxpayer's income in those years, and (2) corporate minutes, a security agreement, promissory notes, and altered accounting records, all dated before, but executed or prepared after, certain advances by a corporation to the taxpayer shareholder, in order to show that the advances were loans rather than constructive dividends. Similarly, each of the other cases petitioners cite in support of their argument that courts uniformly disregard (and may even find fraudulent) backdated documents involves taxpayer efforts to use those documents solely in order to achieve a tax result dependent upon timely action by the taxpayer, where the time to act had already passed. See e.g., United States v. Whistler, 139 Fed. Appx. 1 (9th Cir. 2005); Dobrich v. Commissioner, T.C. Memo. 1997-477, supplemented T.C. Memo. 1998-39, affd. without published opinion 188 F.3d 512 (9th Cir. 1999); Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455. The circumstances described in the cases cited by petitioners are factually distinguishable from the circumstances surrounding the execution of the assignment and assumption agreement. Those cases are, therefore, inapposite.11

(3) The Effective Date Included in the Assignment and Assumption Agreement Was Not a Mutual Mistake Reformable by Parol Evidence Under Georgia Law

As noted supra, petitioners also argue, and respondent disputes, that the specification in the assignment and assumption agreement of a January 1, 1997, effective date was a mistake that may be reformed under Georgia Law. Although we agree with petitioners that the resolution of the issue is governed by Georgia law, see, e.g., Estate of Holland v. Commissioner, T.C. Memo. 1997-302 (issue of whether decedent's conveyance with respect to her Atlanta, Georgia, residence to her children could be reformed to carry out her actual intention to convey a life estate rather than the fee simple interest mistakenly specified in the conveyance governed by Georgia law), we disagree that the effective date provision was a drafting error or mistake subject to reformation under Georgia law.

Ga. Code Ann. sec. 23-2-21 (1982) provides as follows:

What mistakes relievable in equity; power to relieve to be exercised cautiously.

(a) A mistake relievable in equity is some unintentional act, omission, or error arising from ignorance, surprise, imposition, or misplaced confidence.
(b) Mistakes may be either of law or of fact.

(c) The power to relieve mistakes shall be exercised with caution; to justify it, the evidence shall be clear, unequivocal, and decisive as to the mistake.
Ga. Code Ann. sec. 23-2-31 (1982) provides, in pertinent part: "Equity will not reform a written contract unless the mistake is shown to be the mistake of both parties". See also Cox v. Smith, 260 S.E.2d 310, 312-313 (Ga. 1979) ("A 'mutual mistake' in an action for reformation means one in which both parties had agreed on the terms of the contract, but by mistake of the scrivener the true terms of the agreement were not set forth."); Prince v. Friedman, 42 S.E.2d 434, 436 (Ga. 1947) ("jurisdiction [to reform a contract in equity for mutual mistake] will always be cautiously exercised, and to justify it the evidence must be clear, unequivocal, and decisive.").

In this case, there is not "clear, unequivocal, and decisive" evidence of mutual mistake as required by Georgia law. The assignment and assumption agreement plainly states that it is to be effective as of January 1, 1997. It is a brief (two-page) agreement, which makes it unlikely that Ms. Moore was distracted by excessive verbiage so that she failed to notice the effective date provision in the very first sentence of the agreement.

Dr. Joffe testified that he and Ms. Moore agreed to his transfer of a 10-percent membership interest in the LLC to her in 1997 and that, beginning in 1997, the LLC distributions would reflect that shift in membership interest. T. Mills Fleming (Mr. Fleming), an attorney representing Ms. Moore and Dr. McKernan in connection with the sale of their membership interests to Surgicoe, testified that the assignment and assumption agreement was drafted in order to verify to Surgicoe, in writing, that the proceeds from the sale of the LLC membership interests should be allocated on a 68-20-12-percent basis among Drs. Joffe and McKernan and Ms. Moore, respectively. He further testified that the January 1, 1997, effective date was inserted "because that's what the parties represented was the effective date of the transfer of those interests from 88-10-2 to the 68-20-12." Kenneth R. Schwartz (Mr. Schwartz), at the time an associate at Mr. Fleming's firm, worked with Mr. Fleming in his representation of Ms. Moore and Dr. McKernan. He wrote the initial draft of the assignment and assumption agreement. He testified that he and Mr. Fleming assumed that the January 1, 1997, effective date reflected "the way they [Drs. Joffe and McKernan and Ms. Moore] had been treating it"; i.e., their respective membership interests. The testimony of Dr. Joffe, Mr. Fleming, and Mr. Schwartz constitutes evidence that there was an understanding among the members of the LLC (and certainly on Dr. Joffe's part) that the purpose and effect of the assignment and assumption agreement was to formalize their prior oral agreement to have Dr. Joffe transfer 10-percent membership interests to Dr. McKernan and Ms. Moore, effective January 1, 1997.

Dr. Joffe's 1997-2000 Federal income tax returns would reflect whether he respected the LLC Schedule K-1 attributions to him, for those years, of an 88-percent membership interest in the LLC. Respondent argues that petitioners could have subpoenaed Dr. Joffe and required him to produce his tax returns. Indeed, Dr. Joffe did testify, as respondent's witness, and was subject to cross-examination by petitioners' counsel. Petitioners asked him no questions about his 1997-2000 returns. Petitioners' failure to question Dr. Joffe with respect to his returns or require him to produce those returns raises an inference that they would reflect Dr. Joffe's belief that he, in fact, possessed a 68-percent membership interest as of January 1, 1997. See Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158, 1165 (1946) ("the failure of a party to introduce evidence * * * which, if true, would be favorable to him, gives rise to the presumption that if produced it would be unfavorable"), affd. 162 F.2d 513 (10th Cir. 1947).

Neither the Moore letter nor the Joffe memorandum provides convincing evidence that a mutual mistake resulted in the assignment and assumption agreement's recitation of an effective date of January 1, 1997, for the transfer of interests in the LLC by Dr. Joffe to Ms. Moore and Dr. McKernan. Both documents postdate January 1, 1997. Ms. Moore testified that the Moore letter related to a plan that was never implemented to distribute percentages to other physicians that had been loyal and faithful to the LLC. The letter is confusing in that it speaks in terms of percentage distributions "should the * * * [LLC] be sold or distributions be made". (Emphasis added.) The letter does not answer the question: Distributions of what? Sale proceeds? Annual profits? The percentages are identified as percentages of net profit. The letter was written to a lawyer asking for advice on how to accomplish a change to the status quo. Ms. Moore may have in part been concerned with keeping the 10-percent interest in profits that Dr. Joffe testified she was to get beginning in 1997. The Joffe memorandum can be interpreted as confirming a prior agreement that Dr. Joffe would give Ms. Moore an additional 10 percent of the net proceeds of any sale of the LLC, and the failure to reference interim distributions (in addition to sale proceeds) could have been an oversight or simply poor draftsmanship by the doctor. Neither alone nor together are the two documents inconsistent with the conclusion, supported by both the assignment and assumption agreement and the LLC's 1998-2000 distributions to Dr. Joffe, Dr. McKernan, and Ms. Moore (discussed infra) that, before the end of 1997, those three individuals agreed to Dr. Joffe's transfer of an additional 10percent LLC membership interest to each of the other two, and that those transfers were to be effective as of January 1, 1997; i.e., they would result in a 10-percent increase for Dr. McKernan and Ms. Moore and a 20-percent decrease for Dr. Joffe in their respective shares of LLC profit (or loss) for the entire year. Such an agreement could have been finalized at any time during 1997, not necessarily on or before January 1 of that year as petitioners suggest. We find that the Moore letter and the Joffe memorandum fail to provide "clear, unequivocal, and decisive" evidence of mutual mistake.

Nor do the Schedules K-1 attached to the LLC's 1997-2000 returns, the Kelly correspondence, or the SouthTrust Bank credit report provide such evidence.

John Carpentier (Mr. Carpentier) of the accounting firm of Tarpley & Underwood, P.C. the firm that prepared the LLC's 19962000 Federal income tax returns, testified that he prepared the 1996 return and reviewed the subsequent returns. Because no one contacted him to say that the percentage membership interests of the three members changed after 1996, the firm continued in the post-1996 returns to reflect the 88-10-2-percent membership interest allocation on the Schedules K-1 issued to Drs. Joffe and McKernan and Ms. Moore. Mr. Kelly (the lawyer), in his October 28, 1997, letter to Ms. Moore, states: "We understand that [the LLC is owned by Drs. Joffe and McKernan and Ms. Moore on an 88-10-2 percentage basis]." The fact that neither Mr. Carpentier nor Mr. Kelly was made aware of any agreement that might have altered those percentage interests is not evidence that that agreement did not exist, only that it was not communicated to those individuals.

Similarly, the December 1998 SouthTrust Bank credit report supporting the $50,000 March 1999 loan to the LLC determined that Dr. Joffe still owned 88 percent of the LLC, apparently on the basis of the LLC's 1995 return, which describes the 1995 member sales that increased Dr. Joffe's membership interest in the LLC to 88 percent. There is no evidence that Dr. Joffe told SouthTrust Bank in 1998 that he continued to hold an 88-percent membership interest.12

In each instance petitioners cited, the reference to a continuing 88-10-2-percent division of the LLC membership interests is simply based upon the lack of any information to the contrary. None of the documents petitioners cite provides "clear, unequivocal, and decisive evidence" that Dr. Joffe and Ms. Moore had not agreed to the transfer of a 10-percent membership interest in the LLC from the former to the latter as of January 1, 1997.

Lastly, the LLC's 1998-2000 distributions are consistent with an agreement, at least as early as 1998, to allocate the LLC membership interests on a 68-20-12-percent basis among Drs. Joffe and McKernan and Ms. Moore, respectively. Petitioners argue that those so-called disproportionate distributions (disproportionate to the 88-10-2-percent split alleged by petitioners) were merely a means of compensating Dr. McKernan and Ms. Moore for the pledging of LLC assets and the use of LLC funds to discharge debts incurred by Dr. Joffe's failed Cincinnati Surgery Center and were not the result of a prior transfer of 10-percent LLC membership interests from Dr. Joffe to Dr. McKernan and Ms. Moore. Petitioners cite section 8.5

of the LLC operating agreement as permitting interim distributions not in accordance with the recipients' membership interests. In further support of their argument, petitioners rely on the following language taken from a footnote to the LLC's financial statements for 1997 and 1998, which were reviewed by the LLC's outside accountants Tarpley & Underwood, P.C.:

*as a part of * * * [a] refinancing [of long-term debt], one of the members [Dr. Joffe] refinanced other debt, on which the member and the * * * [LLC] are contingently liable in the amount of $3,054,972 at December 31, 1998. Principal and interest payments may be paid personally by the member by distributions from the * * * [LLC]. Proportionate cash distributions will be made to other members of the * * * [LLC].*

We do not agree with petitioners that the foregoing accountant's language describes a disproportionate increase in the distributions to Dr. McKernan and Ms. Moore and a corresponding disproportionate decrease in the distributions to Dr. Joffe. In fact, the reference to "proportionate cash distributions * * * to other members" is consistent with the notion that Dr. McKernan and Ms. Moore were to receive interim distributions proportionate (not disproportionate) to their membership interests.13 Moreover, section 8.5 of the LLC operating agreement is consistent with a general requirement that interim distributions to members of the LLC be proportionate to their membership interests. The operative language provides as follows:

Members * * * may make Distributions to the Members in accordance with their Membership Interests. Such distributions shall be in cash or Property (which need not be distributed proportionately) or partly in both, as determined by the Manager.

A straightforward reading of the foregoing language leads to the conclusion that the parenthetical clause modifies the word "Property", not the word "distributions". Finally, accepting for the sake of argument petitioners' logic for disproportionate distributions among the members of the LLC, they have failed to show us how they arrived at an approximately 68-20-12 split that, coincidentally, mirrored the split under the assignment and assumption agreement. Therefore, we view the LLC's 1998-2000 distributions in relative percentages approximating 68, 20, and 12 among Drs. Joffe and McKernan and Ms. Moore, respectively, as strong evidence that those distributions reflected a 68-20-12percent membership interest allocation in the LLC among those individuals during those years.

In the light of the foregoing, we find no basis for concluding that the effective date provision of the assignment and assumption agreement was caused by a mutual mistake reformable by parol evidence under Georgia law.

b. Dr. Joffe's Transfers of Membership Interests Under the Assignment and Assumption Agreement Were Not Void Because of Noncompliance With Article 10 of the LLC Operating Agreement

Petitioners argue that, because Dr. Joffe's membership interest transfers to Dr. McKernan and Ms. Moore failed to comply with the requirements of article 10 of the LLC operating agreement, governing dispositions of membership interests, and article 6, governing meetings of LLC members, his purported transfer to Ms. Moore, as of January 1, 1997, "is null and void ab initio" pursuant to article 10.7. Petitioners' argument ignores established principles of Georgia law, which provide that contractual provisions may be waived by the mutual consent of the parties to the contract, and that such consent may be established by the parties' course of conduct.14 See, e.g., Handex of Fla., Inc. v. Chatham County, 602 S.E.2d 660, 664 (Ga. Ct. App. 2004) ("While a distinct stipulation in a contract may be waived by the conduct of the parties, it must appear that it was the intention of the parties to treat such stipulation as no longer binding."); Shalom Farms, Inc. v. Columbus Bank & Trust Co., 312 S.E.2d 138, 141 (Ga. Ct. App. 1983) ("To establish the existence of a quasi new agreement would require * * * a showing of mutual * * * intention to vary the terms of the original contract. * * * Such a showing may be implied from the parties' conduct")

The parties to the assignment and assumption agreement, constituting the entire membership of the LLC, voluntarily executed that agreement in the absence of formal notice to the manager of intent to dispose of membership interests and without affording the LLC its right of prior purchase. See articles 10.2 and 10.3 of the LLC operating agreement. Moreover, Dr. Joffe, in his capacity as manager of the LLC, executed a "Waiver of Notice and Right to Purchase" (attached to the assignment and assumption agreement) whereby the LLC formally waived its rights under articles 10.2 and 10.3. We view those actions as constituting mutual consent or agreement, by the parties to the assignment and assumption agreement, to waive the requirements of article 10 of the LLC operating agreement.15 Therefore, the sales of LLC membership interests pursuant to the assignment and assumption agreement were not void by reason of noncompliance with the aforesaid article 10.16

E. Conclusion

Ms. Moore owned a 12-percent membership interest in the LLC during the years at issue (1999 and 2000).

III. The Installment Method Reporting Issue

A. Analysis

Respondent argues that petitioners are not entitled to report their income from the sale of Ms. Moore's membership interest in the LLC under the installment method of section 453. Respondent asserts that petitioners opted out of the installment method, pursuant to section 453(d), "by reporting on their original return all of the income they believed they received in connection with the sale and not filing a Form 6252 [Installment Sale Income] with their original return."

Section 453(d) permits a taxpayer who has made an installment sale to elect out of the installment method of accounting, which, absent the election, would apply to the sale pursuant to section 453(a). Section 15A.453-1(d)(3)(i), Temporary Income Tax Regs., 46 Fed. Reg. 10718 (Feb. 4, 1981), provides, in pertinent part:

A taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurs will be considered to have made an effective election [out of the installment method] * *

On their 2000 return, Schedule D, petitioners reported two items of long-term capital gain: $631,590 described as "partnership interest" and $16,790 described as "note payments". Both items were reported as gross sale price offset by zero basis. The $631,590 approximates the $661,774.01 cash payment from Surgicoe to Ms. Moore at the closing of the sale of her LLC membership interest to Surgicoe that was specified in a "Disbursement Authorization" dated July 29, 2000, and signed by the parties to the Surgicoe purchase agreement.17 The $16,790 equals five payments of $3,358.03, the amount of the monthly payments, to be made the first of each month, beginning September 1, 2000, specified in Surgicoe's promissory note to Ms. Moore.18 Therefore, it is clear that petitioners reported, on their 2000 return, no more than the cash payments received in 2000, not the full amount of the selling price for Ms. Moore's LLC membership interest ($1,138,806.12) and not the full face amount of the Surgicoe promissory note ($160,825.87). Under those circumstances we find that petitioners did not elect out of the installment method of reporting the income from Surgicoe's promissory note. See Estate of Wilkinson v. Commissioner, T.C. Memo. 1993-463 ("The only method for electing out of the installment method * * * is for taxpayers to report the full amount of the sales price and the full amount of the income associated with installment sales on timely filed tax returns for the year of the sales.").

B. Conclusion

Petitioners did not elect out of the installment method in connection with Ms. Moore's 2000 installment sale of her LLC membership interest.

IV. Conclusion
To reflect the foregoing,
Decision will be entered under Rule 155.

PRIVATE LETTER RULING 8103117

Internal Revenue Service (I.R.S.)
Private Letter Ruling
October 27, 1980

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

T:I:I:1:3
X = * * *
$100x = * * *

Dear ***:

This is in reply to a letter dated August 27, 1980, as supplemented by your letter dated September 12, 1980, requesting a ruling regarding the federal income tax consequences of an exchange of certain real property.

You state that in 1963 you purchased a house and lot in X that has never been used as your principal residence. This property was intermittently rented and used for your personal benefit. During the past 6 or 7 years, the house has not been rented and you have occupied it approximately 10 days per year for maintenance purposes.

In 1969 you purchased an unimproved lot, also located in X, which, since your purchase, has not been used for any purpose by you. The stated purpose of both purchases was to provide for personal enjoyment of the community and also to make a sound real estate investment in a growing community. You also represent that you are not realtors and have not purchased or sold any property since 1969.

You state that you are contemplating the exchange of both pieces of real property located at X along with a payment of $100x for another house and lot also located at X. This is to be effected by a single exchange transaction. Nothing in this transaction will affect your principal residence. The house and lot you acquire in this trade will be held for the same purposes as the properties exchanged therefore: to provide for personal enjoyment of the community and to make a sound real estate investment.

Section 1001(c) of the Internal Revenue Code provides that except as otherwise provided in this subtitle, the entire amount of gain or loss determined under this section on the sale or exchange of property shall be recognized.

Section 1031(a) of the Code provides that no gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Accordingly, provided that both the property you will receive and the property you will exchange qualify as property held or to be held for productive use in a trade or business or for investment purposes, the proposed exchange will be an exchange of like kind property within the meaning of section 1031(a) of the Code, and as a result no gain or loss will be recognized by you upon the exchange.

Except as specifically ruled upon, no opinion is expressed as to the federal income tax consequences of the transaction described above under any other provision of the Code.
A copy of this letter should be attached to your federal income tax return for the taxable year in which the transaction is consummated. A copy is enclosed for this purpose.

Sincerely yours,

Anthony Manzanares, Jr.
Chief
Individual Income Tax Branch
This document may not be used or cited as precedent.

ADDITIONAL LIKE-KIND PROPERTY ISSUES

REVENUE RULING 78-4

Advice has been requested whether, under the circumstances described below, the exchange of a remainder interest in one property for a remainder interest in another property will qualify for nonrecognition of gain or loss under the provisions of section 1031(a) of the Internal Revenue Code of 1954.

A and B, who were husband and wife, owned and farmed two tracts of land in a community property state prior to A's death in 1975. Under the terms of A's will, B received a life estate in A's one-half of the community property, with the remainder interest going to the children of A and B. Therefore, B owns one-half of each tract of land in fee simple and has a life estate in the other half of each tract. B farms both tracts of land at the present time for profit.

Under applicable state law, B's fee simple interest is divisible into a life estate and a remainder interest. B proposes to exchange the remainder interest in one-half of one of the tracts of land for the remainder interest of the children in one-half of the other tract of land. No money or other property will be transferred in the exchange since the actuarially determined dollar values of the remainder interests are equal. As a result of such exchange, B will own one tract entirely in fee simple and will have a life estate in all the other tract. After the exchange, B will continue to farm both tracts of land for profit.

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

Section 1.1031(a)-1(b) of the Income Tax Regulations provides, in part, that as used in section 1031(a) of the Code, the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class.

Since the remainder interest of B in one-half of one tract of farm land is of the same nature or character as the remainder interest of the children in one-half of the other tract of farm land, the remainder interests are like kind property within the meaning of section 1.1031(a)-1(b) of the regulations. Therefore, the exchange of B's remainder interest for the children's remainder interest will be an exchange of farm property held for productive use in trade or business solely for like kind property to be held by B for productive use in the business of farming.

Accordingly, the exchange of B's remainder interest in one-half of one tract of land for the remainder interest in one-half of the other tract of land will qualify for nonrecognition of gain or loss under the provisions of section 1031(a) of the Code.

The conclusions in Rev. Rul. 72-601, 1972-2 C.B. 467, are distinguishable from the conclusion in the instant Revenue Ruling. Rev. Rul. 72-601 concludes (1) that a transfer of a life estate in one parcel of real property in return for a remainder interest in another does not qualify as a like kind exchange under section 1031(a) of the Code because the remainder interest received is an advance rental in consideration for the transfer of a right to use real property for a period of years and (2) that a transfer of a remainder interest in one parcel of real property in return for a life estate with an expectancy of less than 30 years in another does not qualify as a like kind exchange under section 1031(a) because the nature and character of the two property interests are not the same.

REVENUE RULING 92-105

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: November 29, 1992

Section 1031 -- Exchange of Property Held for Productive Use or Investment

NONRECOGNITION OF GAIN OR LOSS FROM EXCHAGE OF INTEREST IN ILLINOIS LAND TRUST

Property held for productive use in trade or business or for investment. Nonrecognition of gain or loss from exhange of interest in Illinois land trust. A taxpayer's interest in an Illinois land trust constitutes real property which may be exchanged for other real property without recognition of gain or loss under section 1031 of the Code, provided the requirements of that section are otherwise satisfied.

ISSUE

Does a taxpayer's interest in an Illinois land trust constitute real property which may be exchanged for other real property without recognition of gain or loss under Section 1031 of the Internal Revenue Code?

FACTS

A, an individual, created an Illinois land trust, described in section 8.31 of chapter 29 of the Illinois Annotated Statutes (Smith-Hurd 1990), under which A was the beneficiary. The purpose of the Illinois land trust was to hold title to Blackacre, which is Illinois real property that A has held for investment purposes. Under Illinois state law, a beneficiary's interest in an Illinois land trust is characterized as personal property, the beneficiary or any person designated by the beneficiary has the exclusive power to direct or control the trustee in dealing with the title to the property in the land trust, and the beneficiary has the exclusive control of the management of the property and the exclusive right to the earnings and proceeds from the property.

To create the Illinois land trust, A executed two instruments: (1) a deed in trust; and (2) a land trust agreement. These instruments named T, a domestic corporation, as trustee.

Under the deed in trust, A transferred legal and equitable title in Blackacre to T, subject to the provisions of the accompanying land trust agreement. Pursuant to the deed in trust, any person dealing with T would take any interest in Blackacre free and clear of the claims of A.
The land trust agreement entered into between A and T authorized T, in return for an annual fee, to execute deeds, mortgages, or otherwise deal with the legal title of Blackacre at the direction of A. Under the land trust agreement, A retained the exclusive control of the management, operation, renting, and selling of Blackacre, together with the exclusive right to the earnings and proceeds from Blackacre. A also retained the right to assign A's interest in the Illinois land trust. Under the land trust agreement, A was required to file all tax returns, pay all taxes, and satisfy any other liabilities with respect to Blackacre. The land trust agreement precluded T from disclosing that A was the trust beneficiary unless directed to do so by A in writing. No other agreement regarding Blackacre existed between A and T.

A subsequently entered into a written agreement with X, a domestic corporation, for an exchange of properties. Under the agreement, A agreed to transfer A's interest in the Illinois land trust to X, and X agreed to transfer Whiteacre to A. Whiteacre is real property owned by X and is of a like kind to Blackacre. Pursuant to the agreement, A exchanged A's interest in the Illinois land trust for Whiteacre. Thereafter, A held Whiteacre for investment purposes.

LAW AND ANALYSIS

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 such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(2) of the Code provides that section 1031(a)(1) does not apply to any exchange of specified types of property. In particular, section 1031(a)(2)(E) provides that section 1031(a)(1) does not apply to any exchange of certificates of trust or beneficial interests.

Section 301.7701-4(a) of the Procedure and Administration Regulations provides that the term “trust” as used in the Code refers to an arrangement created by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Generally, an arrangement is treated as a trust under the Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility.

The purpose of the Illinois land trust created by A was to vest legal and equitable title in a “trustee.11 However, under applicable Illinois law, the deed in trust, and the land trust agreement, A retained sole authority and responsibility for dealing directly with Blackacre for all purposes other than the transfer of title. A retained the direct right to manage and control Blackacre, the direct right to collect any rent or sales proceeds from Blackacre, and the direct obligation to pay any taxes and liabilities relating to Blackacre.

Because T's only responsibility was to hold and transfer title at the direction of A, a trust (as defined in section 301.7701-4(a) of the regulations) was not established. Moreover, there were no other agreements between A and T (or between A and any other person) that would cause the overall

arrangement to be classified as a partnership (or any other type of entity) for federal income tax purposes. Cf. Rev. Rul. 64-220, 1964-2 C.B. 335. Instead, T was a mere agent for the holding and transfer of title to Blackacre, and A has retained direct ownership of Blackacre for federal income tax purposes.

Accordingly, A's transfer of A's interest in the Illinois land trust holding title to Blackacre in exchange for Whiteacre was an exchange of the underlying real property, not an exchange of a certificate of trust or beneficial interest (under section 1031(a)(2)(E) of the Code) for Whiteacre. Blackacre is like-kind property to Whiteacre, and provided the requirements of section 1031 are otherwise satisfied, this exchange will qualify for nonrecognition of gain or loss under section 1031.

HOLDING

A taxpayer's interest in an Illinois land trust constitutes real property which may be exchanged for other real property without recognition of gain or loss under section 1031 of the Code, provided the requirements of that section are otherwise satisfied. This holding is not applicable if an arrangement involving an Illinois land trust creates an entity (such as a partnership).

Several states in addition to Illinois, including, for example, California, Florida, Hawaii, Indiana, North Dakota, and Virginia, have laws that statutorily or judicially sanction arrangements that are similar to the Illinois land trust arrangement described herein. The holding in this revenue ruling also applies to an interest in a similar arrangement created under the laws of any state, pursuant to which (1) the trustee has title to real property, (2) the beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee in dealing with the title to the property, and (3) the beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.

DRAFTING INFORMATION

The principal author of this revenue ruling is John M. Fischer of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Fischer on (202) 622-4950 (not a toll-free call).

REVENUE RULING 59-229

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: 1959

Section 1031 — Exchange of Property Held For Productive Use or Investment

26 CFR 1.1031(a)-1

(Also Sections 1016, 1031, 1034, 1231; 1.1016-5, 1.1031(d)-2, 1.1034-1, 1-1231- 1.)

An exchange of unencumbered farm lands, farm buildings, and unharvested crops for 'like property' constitutes a nontaxable exchange within the meaning of section 1031(a) of the Internal Revenue Code of 1954.

Where an exchange of farm properties involves a reciprocal assumption of mortgages, any gain resulting from the exchange of mortgages is subject to the tax treatment under the provisions of section 1231 of the Code.

An exchange of personal residences along with farm lands, buildings, and crops is treated as a separate exchange governed by the applicable provisions of section 1034 of the Code.

Advice has been requested as to the treatment, for Federal income tax purposes, of an exchange of farm properties under the circumstances described below.

The taxpayers, during the taxable year, entered into a transaction in which they mutually exchanged their respective farm properties consisting of farm lands, farm buildings, residences, all held for more than six months, and unharvested crops. The lands, buildings, and residences on both properties involved were burdened with substantial mortgages which were reciprocally assumed by the parties to the exchange.

For Federal income tax purposes, such an exchange raises three distinct problems: (1) the treatment of the exchange of the farm with an unharvested crop thereon for similar property; (2) the treatment of the exchange with respect to the reciprocal assumption of mortgages on the respective properties; and (3) the treatment to be accorded the exchange of the residences with the assumption of mortgages thereon.

Section 1031(a) of the Internal Revenue Code of 1954 provides, in part, as follows:

(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND --

No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, * * *) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Section 1231(b) of the Code, which provides the special rules for determination of capital gains and losses from the sale or exchange of property used in a trade or business, provides, in part, as follows:

(4) UNHARVESTED CROP --

In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as 'property used in the trade or business'.

Inasmuch as section 1231(b)(4) of the Code provides that unharvested crops sold or exchanged with land are considered property used in trade or business, the parenthetical exclusion of section 1031(a) of the Code (stock in trade or other property held primarily for sale) does not apply. The basis of the unharvested crops, in the hands of the vendor or transferor, is adjusted according to section 1016(a)(11) of the Code for production expenses disallowed as a deduction under section 268 of the Code. Thus, where unencumbered farm lands, farm buildings, and unharvested crops are exchanged for 'like property,' no gain or loss is recognized from the transaction. The bases of the properties acquired in the hands of each transferee are the same as the bases to them of the properties which each transferred, as provided in section 1031(d) of the Code.

The second problem, in an exchange of the type under consideration, is the effect of the reciprocal assumption of mortgages.

Section 1031(b) of the Code provides, in part, that if an exchange would be within the provisions of section 1031(a) of the Code except for the fact that the property received in exchange consisted not only of property permitted to be received without recognition of gain, but also of other property or money, then the gain to the recipient is recognized in an amount not exceeding the sum of the money received or the fair market value of the other property.

In Walter F. Haass et al. v. Commissioner, 37 B.T.A. 948, the United States Board of Tax Appeals held that where a taxpayer exchanges mortgaged real estate for other real estate, in an otherwise tax-free 'like kind' exchange, the amount of the mortgage of which he is relieved is treated as the equivalent of 'other property or money.' See also Brons Hotel Inc. v. Commissioner, 34 B.T.A. 376. This holding is incorporated in section 1031(d) of the Code which provides in part, that where, as part of the consideration to the taxpayer, the other party to the exchange assumes a liability of the taxpayer,

such assumption (in the amount of the liability) shall be considered as money received by the taxpayer on the exchange. However, it is a long established rule that the Internal Revenue Service will permit a balancing of liabilities when mortgaged property is exchanged for mortgaged property and each party to the exchange assumes the mortgage of the other party. See G.C.M. 2641, C.B. VI-2, 16 (1927). Therefore, in the instant case, should the mortgages reciprocally assumed not cancel each other, any gain resulting from such assumption is treated as a gain on the sale or exchange of a capital asset under section 1231 and taxed accordingly. However, a loss resulting from such a transaction is not recognized under section 1031(c) of the Code. The bases of the respective properties exchanged are determined according to the rules provided in section 1.1031(d)-2 of the Income Tax Regulations, example (2).

The final consideration, in an exchange of the instant type, is the tax treatment of residences (with mortgages thereon) which are exchanged with the farm properties. If these residences were occupied by tenants acting, for example, in the capacity of caretakers or farm workers for the taxpayers, such exchange would be treated under section 1031(a) of the Code as 'property used in trade or business' in the same manner as the exchange of the farm lands and buildings. However, where the dwellings are used as personal residences by the taxpayers who are parties to the exchange, an exchange thereof is treated as a separate transaction. Any resulting gain is subject to the provisions of section 1034, pertaining to the sale or exchange of a residence. Any loss on the exchange of a personal residence is recognized under section 1002 of the Code, but is not deductible in computing net income, as provided in section 262 of the Code. In such case, the basis of the residence received upon the exchange is its fair market value on the date of the exchange.

Accordingly, it is held that an exchange of unencumbered farm lands, farm buildings and unharvested crops for 'like property' constitutes a nontaxable exchange within the meaning of section 1031(a) of the Code.

Where an exchange of farm properties involves a reciprocal assumption of mortgages, any gain resulting from the exchange of mortgages is subject to the tax treatment under the provisions of section 1231 of the Code. Any loss in such an exchange is not recognized under section 1031(c) of the Code.

An exchange of personal residences along with farm lands, buildings, and crops is treated as a separate exchange governed by the applicable provisions of section 1034 of the Code for gain, and by section 262 of the Code for loss.

REVENUE PROCEDURE 1992-91

Internal Revenue Service (IRS)
Revenue Procedure (Rev. Proc.)
Released: September 19, 2000
Published: October 29, 1992

Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability
[Also Part I, Sections 1012, 167, 162,, 1221, 1031, 1033; 1.1012-1, 1.167(a)-3, 1.162-21, 1.1221-1. 1.1031(a)-2, 1. 1033 (a)-2.)]

SECTION 1. PURPOSE

This revenue procedure provides guidance in a question and answer format on certain federal income tax consequences of the air emission allowance program (the "program") established pursuant to Title IV of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2584 (1990), 42 U.S.C. section 7651 et seq. (the "Act"), with respect to utilities, non-utilities that elect to participate in the program, and other persons that acquire, hold, or transfer sulfur dioxide emission allowances.

SECTION 2. BACKGROUND

The purpose of the Act is to reduce the impact of acid rain through a program of annual allocations of sulfur dioxide omission allowances ("allowances") to certain fossil-fuel- powered combustion devices ("units"), such as boilers, owned by electricity generating companies ("utilities"), The program will be administered by the Environmental Protection Agency (the "EPA") with enforcement beginning in 1995. The Act also provides that other facilities emitting sulfur dioxide ("non-utility facilities") may elect to participate in the program by "opting in" under section 410 of the Act, 42 U.S.C. section 7651i. Persons other than utilities or non- utility facilities may also acquire, hold, and transfer allowances pursuant to section 403(b) of the Act, 42 U.S.C. section 7651b(b).

As provided under the Act, the EPA allocates the allowances to certain units that were operational on November 15, 1990 (the date of the enactment of the Act), and to certain units that become operational after the enactment date but before January 1, 1996. The allocation is based, in part, on the 1985 - 1987 operating levels of each unit covered by the Act. In general, an allowance permits the unit to which it in allocated to emit without penalty one ton of sulfur dioxide. The EPA maintains an allowance account for each covered utility unit, for each non-utility facility that opts into the program, and for any other person that so requests. Only those allowances that are recorded by the EPA in a unit's allowance account an of the allowance transfer deadline for a given year may be applied against the unit's sulfur dioxide emissions during that year.
Except as otherwise provided by the Act, an allowance may be (2) applied against sulfur dioxide emissions occurring in the year to which it has been allocated by the EPA, (2) transferred, (3) sold or exchanged, or (4) held for and applied against sulfur dioxide emissions occurring in a future year. An allowance, however, may not be applied against sulfur dioxide emissions occurring in a year prior to the year to which it has been allocated by the EPA.

Under the Act, the owner or operator of the unit, through the unit's designated representative, must account to the EPA for the total tons of sulfur dioxide emitted by that unit during a calendar year. The designated representative has until the allowance transfer deadline, which occurs at the end of a specified period of time after the close of that calendar year (the "make-up" period), to acquire and record with the EPA allowances sufficient to equal the emissions during that calendar year.

The Act prohibits the operation of any unit in a manner which causes that unit to exceed its sulfur dioxide emission limitation. A unit's emission limitation equals the number of allowances in the unit's allowance account that may be applied against sulfur dioxide emissions of that unit during that calendar year. Bach ton of sulfur dioxide emitted by the unit in excess of its emission limitation in a separate violation of the Act. Under section 411 of the Act,, 42 U.S.C. section 7651j. the owner (or operator) must pay a $2000 penalty to the EPA for each excess ton emitted. In addition, pursuant to that section, the EPA will reduce a subsequent year's allocation of allowances for the unit by the number of allowances equal to the excess tons emitted. Moreover, emission of excess tons may subject the owner (or operator) of the unit to both civil and criminal penalties under the general enforcement provisions of the Clean Air Act.

Section 416 of the Act, 42 U.S.C. section 7651o, directs the EPA to withhold from issuance a small percentage of allowances allocated under the Act to each unit for a particular year. The purposes of this withholding include ensuring that certain power producers (such as the independent paver producers and certain utilities that were not operational before November 15, 1990) that are not allocated any specific allowances under the Act can obtain sufficient allowances to apply against their emissions, and stimulating the market for allowances. These withheld allowances will be deposited in two reserves, one for direct sales and one for auction sales. The proceeds from any sale (direct or auction) will be distributed on a pro-rata basin to the designated representative of the units from which the allowances were withhold. Unsold current-year allowances in the direct sale reserve will be transferred periodically to the auction reserve for sale at the next auction. Unsold allowances remaining in the auction reserve will be returned periodically on a pro-rata basin to the designated representative of units from which the allowances were withheld.

Rev. Rul. 92-16, 1992-12 I.R.B. 5, holds that the allocation of emission allowances by the EPA to a utility does not cause a utility to realize gross income under section 61 of the Internal Revenue Code. Accordingly, a utility's basis in those emission allowances under section 1012 is not measured by reference to the fair market value of the allowances.

To help the Service provide additional guidance on the federal income tax consequences of the emission allowance program, Announcement 92-50, 1992-13 I.R.B. 32, requested public comments on certain tax issues arising from that program that were identified for study. The comments submitted have been carefully considered and the following guidance is provided. Although questions 1 - 7 below are directed to utilities, the federal income tax

consequences for non-utility facilities that opt into the program under section 410 of the Act are similar to those for utilities. Therefore, the answers to questions 1 - 7 generally apply to non-utilities as well as utilities.

SECTION 3. QUESTIONS AND ANSWERS

Q-1: How are the costs of acquiring or holding an emission allowance treated for federal income tax purposes?

A-1: The costs incurred to acquire or hold an emission allowance must be capitalized because the allowance has a useful life substantially beyond the taxable year to which it is allocated. These costs, including any amounts paid to acquire or hold an allowance (such as the purchase price and any properly allocable legal, accounting, and engineering fees), constitute the holder's tax basis in an emission allowance under section 1012 of the Code.
Q-2: Can emission allowances be depreciated under section 167 of the Code?

A-2: An emission allowance is not subject to depreciation under section 167 of the Code. Although an emission allowance confers on its holder the right to emit one ton of sulfur dioxide during a particular calendar year, the omission allowance does not expire in that year if it is not applied against sulfur dioxide emissions, but carries over, without limitation, to subsequent years. Thus, an emission allowance has no ascertainable useful life over which it could be depreciated. Further, it is not subject to gradual exhaustion, wear or tear, or obsolescence over some determinable life within the meaning of section 1.167(a)-1 of the Income Tax Regulations, and its useful life is not limited as required by section 1.167(a)-3. Therefore a unit-of-production method of depreciation is not appropriate.

Q-3: How and when will a utility recover its basin in an omission allowance if that allowance in applied against sulfur dioxide omissions occurring in a particular year?

A-3: A utility will generally be permitted to recover its basis in an emission allowance that is applied against sulfur dioxide emissions occurring in a particular year by deducting the amount of its tax basis in that emission allowance in the year that the sulfur dioxide was emitted. Despite this general rule, however, capitalization will be required in certain instances. See, e.g., sections 263 and 263A of the Code which provide for the capitalization of otherwise deductible expenses in certain instances. If the utility acquires an emission allowance after the end of a calendar year during the "make-up" period provided by the EPA regulations and applies that allowance against the preceding year's emissions, the recovery of its basis in the emission allowance will be determined under the principles of section 461 of the Code.

Q-4: How and when will a utility recover its basis in an emission allowance if the utility sells or exchanges an emission allowance?

A-4: Generally, a utility will recover its basis under section 1001 of the Code on the sale or exchange of an mission allowance. Therefore, a utility will realize capital gain or loss an the sale or exchange of an omission allowance to the extent of the difference between the amount realized and the utility's adjusted basis in that allowance. If, however,, the utility in holding an emission allowance primarily for sale to customers in the ordinary course of a trade or business of dealing in allowances, any gain or loss realized from the sale or exchange will be ordinary. The utility will recognize gain or loss in the year of the sale or exchange, unless a nonrecognition provision of the Code (such as section 1031) applies.

Q-5: Is an exchange of emission allowances an exchange of like-kind property that qualifies for nonrecognition treatment under section 1031 of the Code?

A-5: Emission allowances,, regardless of the year to which the allowances are allocated by the EPA, will be treated as like-kind property for purposes of section 1031 of the Code. Therefore, an exchange of emission allowances that would otherwise result in a taxable event and the recognition of gain or loss under section 1001 is an exchange of like-kind property that qualifies for nonrecognition treatment under section 1031, provided that the requirements of that section are otherwise satisfied.

Q-6: Is the withholding and sale by the EPA Of allowances allocated to the units under section 416 of the Act treated as an involuntary conversion of the withhold allowances for purposes of section 1033 of the Code?

A-6: The withholding and sale by the EPA of allowances allocated to the units under section 416 of the Act will be treated as an involuntary conversion of the withhold allowances for purposes of section 1033 of the Code. In addition, the purchase of other allowances for the purpose of replacing the withheld allowances will be treated an the purchase of property similar or related in service or use to the withheld allowances. Thus, the nonrecognition treatment of section 1033 may be elected with respect to these withheld allowances, provided that the requirements of that section are otherwise satisfied.

Q-7: Is the $2000 per ton "penalty" paid to the EPA under section 411 of the Act for emissions in excess of a unit’s emission limitation deductible under section 162(a) of the Code?

A-7: The purpose of the $2000 per ton penalty imposed by section 411 of the Act is punitive as indicated by the legislative history accompanying the Act. an H. R. Rep. No. 490 (Part 2), 101st Cong., 2nd Sess. 5 (1990). Thus, this exaction is a penalty within the meaning of section 162(f) of the Code and section 1.162-21 of the regulations, and is not deductible under section 162(a). However, the reduction of future emission allowances under section 411 of the Act as a result of excess emissions is not a penalty within the meaning of section 162(f) and will not preclude any deduction of the basis of those allowances in the year of the reduction.

Q-8: What are the federal income tax consequences of participation in the emission allowance program by a person that is an investor or trader?

A-8: The federal income tax consequences for questions and answers 1, 2, 4, and 5 are the same as for a utility. Questions 3, 6, and 7 do not apply.

SECTION. 4. EFFECTIVE DATE

This revenue procedure is effective November 16, 1992
DRAFTING INFORMATION

The principal author of this revenue procedure is Kathryn R. Nunzio of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mrs. Nunzio on (202) 622- 4950 (not a toll-free call).

PRIVATE LETTER RULING 200651025

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: December 22, 2006
September 12, 2006

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Shareholder =
Corporation =
Subsidiary =
S =
T =
$V =
W =
X =
County Y =
State Z =
Year 1 =
Year 2 =
Year 3 =
Date 1 =

Dear ***:

This responds to your request for a private letter ruling, dated October 7, 2005, as later amended. Specifically, you have asked us to rule that a transaction involving the grant of an easement for land use credits using a qualified intermediary, and the subsequent acquisition by the qualified intermediary of replacement property using proceeds from the sale of the credits may qualify as an exchange of like-kind property under Section 1031 of the Internal Revenue Code.

FACTS:

A. Background

In recent years, State Z has enacted laws designed to control and regulate its growth. Its legislature recognized a need for innovative planning and development strategies to address the anticipated demands of continued urbanization of State Z's coastal and other environmentally sensitive areas. The goal of the legislature was to accommodate less populated regions of the state which seek economic growth and which have suitable land and water resources to accommodate growth in an environmentally acceptable manner. The legislature further recognized the substantial advantages of innovative approaches to development which may better protect environmentally sensitive areas, maintain the economic viability of agricultural and other predominantly rural land uses, and provide for the cost-efficient delivery of public facilities and services.

One such innovative approach adopted was a program for encouraging the designation by local governments of agricultural lands as rural land stewardship areas. A rural land stewardship area includes both a "stewardship sending area" (SSA) and a "stewardship receiving area" (SRA) between which "transferable rural land use credits" (also known as "stewardship credits" or "credits") are "sent" and "received." Under this rural land stewardship area program, a local government, in conjunction with a regional planning council, a stakeholder organization of private land owners, or another local government, must notify State Z in writing of its intent to designate a rural land stewardship area. The written notification must describe the basis for the designation, including the extent to which the rural land stewardship area enhances rural land values, controls urban sprawl, provides necessary open space for agriculture and protection of the natural environment, promotes rural economic activity, and maintains the rural character and economic viability of local agriculture.

Under the statute, counties designate rural land stewardship areas as overlays on a future land use map. A rural land stewardship area cannot be less than 10,000 acres, must be located outside of municipalities and established urban growth boundaries, and must be designated by "plan amendment" (hereinafter referred to as a "plan"). A plan designating a rural land stewardship area is subject to review by the Department of Community Affairs and must provide, inter alia, criteria for the designation of receiving areas within rural land stewardship areas in which innovative planning and development strategies may be applied. The criteria provide, at a minimum, for the following: (a) the adequacy of suitable land to accommodate development to avoid conflict with environmentally sensitive areas, resources, and habitats; (b) compatibility between and transition from higher density uses to lower intensity rural uses; (c) the establishment of receiving area service boundaries which provide for a separation between receiving areas and other land uses within the rural land stewardship area through limitations on the extension of services; and (d) connection of receiving areas with the rest of the rural land stewardship area using rural design and rural road corridors.

A receiving area must be designated by the adoption of a land development regulation. Prior to the designation of a receiving area, the local government must provide the Department of Community Affairs a period of 30 days in which to review a proposed receiving area for consistency with the rural land stewardship area plan and to provide comments to the local government.

At the time of designation of a stewardship receiving area, a listed species survey must be performed. If listed species are present on the receiving area site, the developer must coordinate with each appropriate local, state, or federal agency to determine if adequate provisions have been made to protect those species in accordance with applicable regulations. In determining the adequacy of provisions for the protection of listed species and their habitats, the rural land stewardship area is considered as a whole. The impact on areas to be developed as receiving areas must be considered together with the environmental benefits of areas protected as sending areas in fulfilling this criterion.

Upon the adoption of a plan creating a rural land stewardship area, the local government must, by ordinance, establish the methodology for the creation, conveyance, and use of stewardship credits, the application of which shall not constitute a right to develop land, nor increase density of use of the land, except as provided. The total amount of stewardship credits within the rural land stewardship area must enable the realization of the long-term vision and goals respecting land use and community development of the local governments, within statutory parameters. Stewardship credits are also subject to certain limitations, including the following:

1. Stewardship credits may only exist within a rural land stewardship area.

2. Stewardship credits may only be used on lands designated as receiving areas and then solely for the purpose of implementing innovative planning and development strategies and creative land use planning techniques adopted by the local government.

3. An increase in the density of use on a parcel of land located within a designated receiving area may occur only through the assignment or use of stewardship credits.

4. A change in the density of land use on parcels located within receiving areas must be specified in a development order which reflects the total number of stewardship credits assigned to the parcel of land and the infrastructure and support services necessary to provide for a functional mix of land uses corresponding to the plan of development.

5. Stewardship credits may be assigned at different ratios of credits per acre according to the natural resource or other beneficial use characteristics of the land and according to the remaining land use following the transfer of credits. The highest numbers of credits per acre are assigned to the most environmentally valuable land or to locations where the retention of open space and agricultural land is a priority.

6. The use or conveyance of stewardship credits must be recorded in the public records of the county in which the property is located as a covenant or restrictive (stewardship) easement running with the land in favor of the county and either the Department of Environmental Protection, the Department of Agriculture and Consumer Services, a water management district, or a recognized statewide land trust.

B. The Transaction

Corporation owns approximately X acres of ranch property located in County Y, State Z. Since Year 1, Corporation has engaged in the cattle ranching business on that land. Shareholder is Corporation's largest shareholder. Shareholder separately owns about S acres of ranch property located in County Y, State Z, which he acquired in Year 2. Subsidiary, a wholly owned subsidiary of Corporation, separately owns T acres of real property located in County Y, State Z and has engaged in the business of growing and producing fruit on that property since Year 3.

Corporation, Shareholder, and Subsidiary are not in a partnership or joint venture with each other. They have never filed a partnership income tax return with respect to the ownership of the land that is the subject of this letter. Although Corporation and Subsidiary are consolidated taxpayers, they operate separate businesses, retaining different employees. Although Corporation uses Shareholder's separate property in its cattle business, it pays regular fees for the right to do so. The parties do not carry on any joint business activity. Hereafter, Corporation, Shareholder and Subsidiary are together referred to as "Taxpayer" and the lands at issue, which they separately own, are collectively referred to as the "Ranch."

On Date 1, Taxpayer entered into a "Contract for Sale and Purchase of Stewardship Credits and Agreement to Create Rural Land Stewardship Regarding [the Ranch]" (the Contract), with Buyer, an unrelated individual in the land development business. Pursuant to the Contract, the parties agreed to create a rural land stewardship overlay on the Ranch in accordance with statutes of State Z. This action would include the elimination by Taxpayer of certain land use layers from about W acres of the Ranch pursuant to a separate SSA Credit Agreement (Credit Agreement) and granting a perpetual restrictive stewardship easement to County Y pursuant to a separate Stewardship Easement Agreement (Easement Agreement). These actions, which will impair the value of the Ranch, will amount to a legal inducement of County Y to grant stewardship credits (credits) that reflect the value of the property rights that Taxpayer permanently relinquishes. Buyer will purchase the credits pursuant to the Contract for the expected sum of $V (depending on the number of credits generated) from Taxpayer through a qualified intermediary (QI). Taxpayer will structure this transaction as a like-kind exchange using a QI as defined by Section 1.1031(k)-1(g)(4)(iii) of the Income Tax Regulations. Taxpayer will comply in all other respects with the requirements of the QI safe harbor as outlined in Section 1.1031(k)-1(g)(4). Among other things, that regulation requires that a taxpayer seeking exchange treatment to enter into an exchange agreement with a QI. Pursuant to that agreement, the QI "acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." See Section 1.1031(k)-1(g)(4)(iii)(B). The regulation also requires that the QI enter into an agreement with a person other than the taxpayer for the transfer of the relinquished property. The regulation specifically provides that this requirement may be satisfied if the rights of a party to the agreement (in this context, Taxpayer's rights in the Contract, the Credit Agreement and the Easement Agreement) are assigned to the QI and all parties to these agreements are notified in writing of the assignments, on or before the date of the relevant transfer of property. See Section 1.1031(k)-1(g)(4)(v).

More particularly, Taxpayer will assign its rights under the Contract to a QI before Taxpayer and County Y enter into the Credit Agreement and before Taxpayer, County Y and State Z's Department of Agriculture and Consumer Services enter into the Easement Agreement. Subsequent to that assignment, but prior to the closing, the Credit Agreement and the Easement Agreement will also be assigned to the QI. Each of these assignments will

be made in the manner consistent with Section 1.1031(k)-1(g)(4)(v). By assigning its rights to the credits to the QI prior to the awarding of such credits, Taxpayer will not have actual or constructive receipt of the credits or the relinquished property proceeds.

Upon closing, Buyer will pay the relinquished property proceeds directly to the QI pursuant to these assignments and receive, in exchange therefor, the stewardship credits. These credits will entitle Buyer to develop real property it owns in a manner not permitted in the absence of the credits. Once Buyer pays the QI for the credits, the QI will use the money thus derived to acquire other real estate identified by Taxpayer as its replacement property.

Taxpayer and the QI will act in such manner as to insure full and timely compliance with the identification period and replacement period requirements set forth in Section 1031(a)(3)(A) and (B) (as well as Rev. Proc. 2000-37, 2000-2 C.B. 308, as applicable). Taxpayer held the relinquished property and will hold the replacement property for "productive use in a trade or business or for investment" as required by Section 1031(a)(1). As noted previously, Section 1.1031(k)-1(g)(4)(iii)(B) requires that the QI acquire and transfer the replacement property to Taxpayer. For this purpose, the QI will be treated as having acquired and transferred the replacement property if the QI enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to Taxpayer. Section 1.1031(k)-1(g)(4)(v) provides that a QI will be treated as having entered into an agreement (for the acquisition of replacement property) if the rights of a party to the agreement are assigned to the QI and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the replacement property. In this case, Taxpayer will identify one or more replacement properties, enter into agreements with the owners of such properties for their acquisition and, prior to the closings of such acquisition(s), assign its rights as purchaser under such agreements to the QI. Upon the closing of such acquisition(s), the QI will pay the seller(s) of the replacement property out of proceeds from the sale of the relinquished property and such sellers will convey title to the replacement property (or properties) directly to Taxpayer.

LAW AND ANALYSIS:

Section 1031(a)(1) provides 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 1.1031(a)-1(b) provides, in part, that the words like kind refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

As examples of exchanges of property of like kind, Section 1.1031(a)-1(c) provides that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

A number of revenue rulings, three of which are summarized below, address the issue of the character of easements as real property. In Rev. Rul. 55-749, 1955-2 C.B. 295, land was exchanged for perpetual water rights, which are considered real property rights under the applicable state law. The ruling holds that the fee interest in the land and a water right in perpetuity are sufficiently similar to constitute property of like kind for purposes of Section 1031(a).

In Rev. Rul. 59-121, 1959-1 C.B. 212, the taxpayer granted an easement of indefinite duration over specified portions of its land. The grantee of the easement intended to construct a dam and reservoir on the land and to use of portions of the land for the deposit of industrial waste. While the taxpayer retained mineral rights and rights to otherwise enjoy the land and any buildings thereon, the taxpayer was prohibited from interfering with the easement granted. The revenue ruling provides that, since "the easement is with respect to land, it constitutes an interest in real property", and the proceeds derived from the sale of the easement constitute proceeds from the sale of an interest in real property.

Finally, Rev. Rul. 72-549, 1972-2 C.B. 472, provides that an easement and right-of-way granted to an electric power company are properties of like kind to both real property with nominal improvements and real property improved with an apartment building.

With respect to Taxpayer's ruling request, the stewardship easement will be in perpetuity and arises out of Taxpayer's interest in the underlying land. Such easements are also interests in real property under the laws of State Z. In effect, Taxpayer will exchange a perpetual stewardship easement for a fee simple interest in like-kind property in a deferred exchange, using the safe harbor provided under Section 1.1031(k)-1(g)(4). The steps in the transaction, to the extent outlined above, conform to the rules of that safe harbor. Therefore, we rule as follows:

1. A perpetual stewardship easement of the type described in the facts presented is of like kind to a fee interest in other real property; and

2. The use of the proceeds from the relinquished perpetual stewardship easement (i.e., the cash proceeds derived from the credits which are issued to Buyer through the QI by assignments in connection with Taxpayer's grant of such easement) to purchase one or more fee interests in real property to be held by Taxpayer for productive use in a trade or business or for investment will not disqualify the transaction from tax deferred exchange treatment under Section 1031.

CAVEAT(S):

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. Specifically, we express no opinion whether the proposed transaction qualifies in all other respects for tax

deferral under Section 1031 beyond what is expressly stated in the above ruling. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under Section 6110.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200681018

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: December 22, 2006
September 13, 2006

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Subsidiary =
Shareholder =
Corporation =
S =
T =
$V =
W =
X =
County Y =
State Z =
Year 1 =
Year 2 =
Year 3 =
Date 1 =

Dear ***:

This responds to your request for a private letter ruling, dated June 2, 2006. Specifically, you have asked us to rule that a transaction involving the grant of an easement for land use credits using a qualified intermediary, and the subsequent acquisition by the qualified intermediary of replacement property using proceeds from the sale of the credits may qualify as an exchange of like-kind property under Section 1031 of the Internal Revenue Code.

FACTS:

A. Background

In recent years, State Z has enacted laws designed to control and regulate its growth. Its legislature recognized a need for innovative planning and development strategies to address the anticipated demands of continued urbanization of State Z's coastal and other environmentally sensitive areas. The goal of the legislature was to accommodate less populated regions of the state which seek economic growth and which have suitable land and water resources to accommodate growth in an environmentally acceptable manner. The legislature further recognized the substantial advantages of innovative approaches to development which may better protect environmentally sensitive areas, maintain the economic viability of agricultural and other predominantly rural land uses, and provide for the cost-efficient delivery of public facilities and services.

One such innovative approach adopted was a program for encouraging the designation by local governments of agricultural lands as rural land stewardship areas. A rural land stewardship area includes both a "stewardship sending area" (SSA) and a "stewardship receiving area" (SRA) between which "transferable rural land use credits" (also known as "stewardship credits" or "credits") are "sent" and "received."

Under this rural land stewardship area program, a local government, in conjunction with a regional planning council, a stakeholder organization of private land owners, or another local government, must notify State Z in writing of its intent to designate a rural land stewardship area. The written notification must describe the basis for the designation, including the extent to which the rural land stewardship area enhances rural land values, controls urban sprawl, provides necessary open space for agriculture and protection of the natural environment, promotes rural economic activity, and maintains the rural character and economic viability of local agriculture.

Under the statute, counties designate rural land stewardship areas as overlays on a future land use map. A rural land stewardship area cannot be less than 10,000 acres, must be located outside of municipalities and established urban growth boundaries, and must be designated by "plan amendment" (hereinafter referred to as a "plan"). A plan designating a rural land stewardship area is subject to review by the Department of Community Affairs and must provide, inter alia, criteria for the designation of receiving areas within rural land stewardship areas in which innovative planning and development strategies may be applied. The criteria provide, at a minimum, for the following: (a) the adequacy of suitable land to accommodate development to avoid conflict with environmentally sensitive areas, resources, and habitats; (b) compatibility between and transition from higher density uses to lower intensity rural uses; (c) the establishment of receiving area service boundaries which provide for a separation between receiving areas and other land uses within the rural land stewardship area through limitations on the extension of services; and (d) connection of receiving areas with the rest of the rural land stewardship area using rural design and rural road corridors.
A receiving area must be designated by the adoption of a land development regulation. Prior to the designation of a receiving area, the local government must provide the Department of Community Affairs a period of 30 days in which to review a proposed receiving area for consistency with the rural land stewardship area plan and to provide comments to the local government.

At the time of designation of a stewardship receiving area, a listed species survey must be performed. If listed species are present on the receiving area site, the developer must coordinate with each appropriate local, state, or federal agency to determine if adequate provisions have been made to protect those species in accordance with applicable regulations. In determining the adequacy of provisions for the protection of listed species and their habitats, the rural land stewardship area is considered as a whole. The impact on areas to be developed as receiving areas must be considered together with the environmental benefits of areas protected as sending areas in fulfilling this criterion.

Upon the adoption of a plan creating a rural land stewardship area, the local government must, by ordinance, establish the methodology for the creation, conveyance, and use of stewardship credits, the application of which shall not constitute a right to develop land, nor increase density of use of the land, except as provided. The total amount of stewardship credits within the rural land stewardship area must enable the realization of the long-term vision and goals respecting land use and community development of the local governments, within statutory parameters. Stewardship credits are also subject to certain limitations, including the following:

1. Stewardship credits may only exist within a rural land stewardship area.

2. Stewardship credits may only be used on lands designated as receiving areas and then solely for the purpose of implementing innovative planning and development strategies and creative land use planning techniques adopted by the local government.

3. An increase in the density of use on a parcel of land located within a designated receiving area may occur only through the assignment or use of stewardship credits.

4. A change in the density of land use on parcels located within receiving areas must be specified in a development order which reflects the total number of stewardship credits assigned to the parcel of land and the infrastructure and support services necessary to provide for a functional mix of land uses corresponding to the plan of development.

5. Stewardship credits may be assigned at different ratios of credits per acre according to the natural resource or other beneficial use characteristics of the land and according to the remaining land use following the transfer of credits. The highest numbers of credits per acre are assigned to the most environmentally valuable land or to locations where the retention of open space and agricultural land is a priority.

6. The use or conveyance of stewardship credits must be recorded in the public records of the county in which the property is located as a covenant or restrictive (stewardship) easement running with the land in favor of the county and either the Department of Environmental Protection, the Department of Agriculture and Consumer Services, a water management district, or a recognized statewide land trust.

B. The Transaction

Corporation owns approximately X acres of ranch property located in County Y, State Z. Since Year 1, Corporation has engaged in the cattle ranching business on that land. Shareholder is Corporation's largest shareholder. Shareholder separately owns about S acres of ranch property located in County Y, State Z, which he acquired in Year 2. Subsidiary, a wholly owned subsidiary of Corporation, separately owns T acres of real property located in County Y, State Z and has engaged in the business of growing and producing fruit on that property since Year 3.

Corporation, Shareholder, and Subsidiary are not in a partnership or joint venture with each other. They have never filed a partnership income tax return with respect to the ownership of the land that is the subject of this letter. Although Corporation and Subsidiary are consolidated taxpayers, they operate separate businesses, retaining different employees. Although Corporation uses Shareholder's separate property in its cattle business, it pays regular fees for the right to do so. The parties do not carry on any joint business activity. Hereafter, Corporation, Shareholder and Subsidiary are together referred to as "Taxpayer" and the lands at issue, which they separately own, are collectively referred to as the "Ranch."

On Date 1, Taxpayer entered into a "Contract for Sale and Purchase of Stewardship Credits and Agreement to Create Rural Land Stewardship Regarding [the Ranch]" (the Contract), with Buyer, an unrelated individual in the land development business. Pursuant to the Contract, the parties agreed to create a rural land stewardship overlay on the Ranch in accordance with statutes of State Z. This action would include the elimination by Taxpayer of certain land use layers from about W acres of the Ranch pursuant to a separate SSA Credit Agreement (Credit Agreement) and granting a perpetual restrictive stewardship easement to County Y pursuant to a separate Stewardship Easement Agreement (Easement Agreement). These actions, which will impair the value of the Ranch, will amount to a legal inducement of County Y to grant stewardship credits (credits) that reflect the value of the property rights that Taxpayer permanently relinquishes. Buyer will purchase the credits pursuant to the Contract for the expected sum of $V (depending on the number of credits generated) from Taxpayer through a qualified intermediary (QI).

Taxpayer will structure this transaction as a like-kind exchange using a QI as defined by Sectino 1.1031(k)-1(g)(4)(iii) of the Income Tax Regulations. Taxpayer will comply in all other respects with the requirements of the QI safe harbor as outlined in Section 1.1031(k)-1(g)(4). Among other things, that regulation requires that a taxpayer seeking exchange treatment to enter into an exchange agreement with a QI. Pursuant to that agreement, the QI "acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." See Section 1.1031(k)-1(g)(4)(iii)(B). The regulation also requires that the QI enter into an agreement with a person other than the taxpayer for the transfer of the relinquished property. The regulation specifically provides that this requirement may be satisfied if the rights of a party to the agreement (in this context, Taxpayer's rights in the Contract, the Credit Agreement and the Easement Agreement) are assigned to the QI and all parties to these agreements are notified in writing of the assignments, on or before the date of the relevant transfer of property. See Section 1.1031(k)- 1(g)(4)(v).

More particularly, Taxpayer will assign its rights under the Contract to a QI before Taxpayer and County Y enter into the Credit Agreement and before Taxpayer, County Y and State Z's Department of Agriculture and Consumer Services enter into the Easement Agreement. Subsequent to that assignment, but prior to the closing, the Credit Agreement and the Easement Agreement will also be assigned to the QI. Each of these assignments will

be made in the manner consistent with Section 1.1031(k)-1(g)(4)(v). By assigning its rights to the credits to the QI prior to the awarding of such credits, Taxpayer will not have actual or constructive receipt of the credits or the relinquished property proceeds.

Upon closing, Buyer will pay the relinquished property proceeds directly to the QI pursuant to these assignments and receive, in exchange therefor, the stewardship credits. These credits will entitle Buyer to develop real property it owns in a manner not permitted in the absence of the credits. Once Buyer pays the QI for the credits, the QI will use the money thus derived to acquire other real estate identified by Taxpayer as its replacement property.

Taxpayer and the QI will act in such manner as to insure full and timely compliance with the identification period and replacement period requirements set forth in Â§ 1031(a)(3)(A) and (B) (as well as Rev. Proc. 2000-37, 2000-2 C.B. 308, as applicable). Taxpayer held the relinquished property and will hold the replacement property for "productive use in a trade or business or for investment" as required by Section 1031(a)(1). As noted previously, Section 1.1031(k)-1(g)(4)(iii)(B) requires that the QI acquire and transfer the replacement property to Taxpayer. For this purpose, the QI will be treated as having acquired and transferred the replacement property if the QI enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to Taxpayer. Section 1.1031(k)-1(g)(4)(v) provides that a QI will be treated as having entered into an agreement (for the acquisition of replacement property) if the rights of a party to the agreement are assigned to the QI and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the replacement property. In this case, Taxpayer will identify one or more replacement properties, enter into agreements with the owners of such properties for their acquisition and, prior to the closings of such acquisition(s), assign its rights as purchaser under such agreements to the QI. Upon the closing of such acquisition(s), the QI will pay the seller(s) of the replacement property out of proceeds from the sale of the relinquished property and such sellers will convey title to the replacement property (or properties) directly to Taxpayer.

LAW AND ANALYSIS:

Section 1031(a)(1) provides 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 1.1031(a)-1(b) provides, in part, that the words like kind refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

As examples of exchanges of property of like kind, Section 1.1031(a)-1(c) provides that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.
A number of revenue rulings, three of which are summarized below, address the issue of the character of easements as real property. In Rev. Rul. 55-749, 1955-2 C.B. 295, land was exchanged for perpetual water rights, which are considered real property rights under the applicable state law. The ruling holds that the fee interest in the land and a water right in perpetuity are sufficiently similar to constitute property of like kind for purposes of Section 1031(a).
In Rev. Rul. 59-121, 1959-1 C.B. 212, the taxpayer granted an easement of indefinite duration over specified portions of its land. The grantee of the easement intended to construct a dam and reservoir on the land and to use of portions of the land for the deposit of industrial waste. While the taxpayer retained mineral rights and rights to otherwise enjoy the land and any buildings thereon, the taxpayer was prohibited from interfering with the easement granted. The revenue ruling provides that, since "the easement is with respect to land, it constitutes an interest in real property", and the proceeds derived from the sale of the easement constitute proceeds from the sale of an interest in real property.

Finally, Rev. Rul. 72-549, 1972-2 C.B. 472, provides that an easement and right-of-way granted to an electric power company are properties of like kind to both real property with nominal improvements and real property improved with an apartment building.

With respect to Taxpayer's ruling request, the stewardship easement will be in perpetuity and arises out of Taxpayer's interest in the underlying land. Such easements are also interests in real property under the laws of State Z. In effect, Taxpayer will exchange a perpetual stewardship easement for a fee simple interest in like-kind property in a deferred exchange, using the safe harbor provided under Section 1.1031(k)-1(g)(4). The steps in the transaction, to the extent outlined above, conform to the rules of that safe harbor. Therefore, we rule as follows:

1. A perpetual stewardship easement of the type described in the facts presented is of like kind to a fee interest in other real property; and

2. The use of the proceeds from the relinquished perpetual stewardship easement (i.e., the cash proceeds derived from the credits which are issued to Buyer through the QI by assignments in connection with Taxpayer's grant of such easement) to purchase one or more fee interests in real property to be held by Taxpayer for productive use in a trade or business or for investment will not disqualify the transaction from tax deferred exchange treatment under Section 1031.

CAVEAT(S):

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. Specifically, we express no opinion whether the proposed transaction qualifies in all other respects for tax deferral under Section 1031 beyond what is expressly stated in the above ruling. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under Section 6110.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200649028

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: December 8, 2006
September 8, 2006

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Corporation = * * *
Shareholder = * * *
Subsidiary = * * *
S = * * *
T = * * *
$V = * * *
W = * * *
X = * **
County Y = * * *
State Z = * * *
Year 1 = * * *
Year 2 = * * *
Year 3 = * * *
Date 1 = * * *

Dear * * *:

This responds to your request for a private letter ruling, dated October 7, 2005. Specifically, you have asked us to rule that a transaction involving the grant of an easement for land use credits using a qualified intermediary, and the subsequent acquisition by the qualified intermediary of replacement property using proceeds from the sale of the credits may qualify as an exchange of like-kind property under Section 1031 of the Internal Revenue Code.

FACTS

A. Background

In recent years, State Z has enacted laws designed to control and regulate its growth. Its legislature recognized a need for innovative planning and development strategies to address the anticipated demands of continued urbanization of State Z's coastal and other environmentally sensitive areas. The goal of the legislature was to accommodate less populated regions of the state which seek economic growth and which have suitable land and water resources to accommodate growth in an environmentally acceptable manner.

The legislature further recognized the substantial advantages of innovative approaches to development which may better protect environmentally sensitive areas, maintain the economic viability of agricultural and other predominantly rural land uses, and provide for the cost-efficient delivery of public facilities and services.

One such innovative approach adopted was a program for encouraging the designation by local governments of agricultural lands as rural land stewardship areas. A rural land stewardship area includes both a "stewardship sending area" (SSA) and a "stewardship receiving area" (SRA) between which "transferable rural land use credits" (also known as "stewardship credits" or "credits") are "sent" and "received."

Under this rural land stewardship area program, a local government, in conjunction with a regional planning council, a stakeholder organization of private land owners, or another local government, must notify State Z in writing of its intent to designate a rural land stewardship area. The written notification must describe the basis for the designation, including the extent to which the rural land stewardship area enhances rural land values, controls urban sprawl, provides necessary open space for agriculture and protection of the natural environment, promotes rural economic activity, and maintains the rural character and economic viability of local agriculture.

Under the statute, counties designate rural land stewardship areas as overlays on a future land use map. A rural land stewardship area cannot be less than 10,000 acres, must be located outside of municipalities and established urban growth boundaries, and must be designated by "plan amendment" (hereinafter referred to as a "plan"). A plan designating a rural land stewardship area is subject to review by the Department of Community Affairs and must provide, inter alia, criteria for the designation of receiving areas within rural land stewardship areas in which innovative planning and development strategies may be applied.

The criteria provide, at a minimum, for the following: (a) the adequacy of suitable land to accommodate development to avoid conflict with environmentally sensitive areas, resources, and habitats; (b) compatibility between and transition from higher density uses to lower intensity rural uses; (c) the establishment of receiving area service boundaries which provide for a separation between receiving areas and other land uses within the rural land stewardship area through limitations on the extension of services; and (d) connection of receiving areas with the rest of the rural land stewardship area using rural design and rural road corridors.

A receiving area must be designated by the adoption of a land development regulation.

Prior to the designation of a receiving area, the local government must provide the Department of Community Affairs a period of 30 days in which to review a proposed receiving area for consistency with the rural land stewardship area plan and to provide comments to the local government.

At the time of designation of a stewardship receiving area, a listed species survey must be performed. If listed species are present on the receiving area site, the developer must coordinate with each appropriate local, state, or federal agency to determine if adequate provisions have been made to protect those species in accordance with applicable regulations. In determining the adequacy of provisions for the protection of listed species and their habitats, the rural land stewardship area is considered as a whole. The impact on areas to be developed as receiving areas must be considered together with the environmental benefits of areas protected as sending areas in fulfilling this criterion.

Upon the adoption of a plan creating a rural land stewardship area, the local government must, by ordinance, establish the methodology for the creation, conveyance, and use of stewardship credits, the application of which shall not constitute a right to develop land, nor increase density of use of the land, except as provided. The total amount of stewardship credits within the rural land stewardship area must enable the realization of the long-term vision and goals respecting land use and community development of the local governments, within statutory parameters. Stewardship credits are also subject to certain limitations, including the following:

1. Stewardship credits may only exist within a rural land stewardship area.

2. Stewardship credits may only be used on lands designated as receiving areas and then solely for the purpose of implementing innovative planning and development strategies and creative land use planning techniques adopted by the local government.
3. An increase in the density of use on a parcel of land located within a designated receiving area may occur only through the assignment or use of stewardship credits.

4. A change in the density of land use on parcels located within receiving areas must be specified in a development order which reflects the total number of stewardship credits assigned to the parcel of land and the infrastructure and support services necessary to provide for a functional mix of land uses corresponding to the plan of development.

5. Stewardship credits may be assigned at different ratios of credits per acre according to the natural resource or other beneficial use characteristics of the land and according to the remaining land use following the transfer of credits. The highest numbers of credits per acre are assigned to the most environmentally valuable land or to locations where the retention of open space and agricultural land is a priority.
6. The use or conveyance of stewardship credits must be recorded in the public records of the county in which the property is located as a covenant or restrictive (stewardship) easement running with the land in favor of the county and either the Department of Environmental Protection, the Department of Agriculture and Consumer Services, a water management district, or a recognized statewide land trust.

B. The Transaction

Corporation owns approximately X acres of ranch property located in County Y, State Z. Since Year 1, Corporation has engaged in the cattle ranching business on that land. Shareholder is Corporation's largest shareholder. Shareholder separately owns about S acres of ranch property located in County Y, State Z, which he acquired in Year 2. Subsidiary, a wholly owned subsidiary of Corporation, separately owns T acres of real property located in County Y, State Z and has engaged in the business of growing and producing fruit on that property since Year 3.

Corporation, Shareholder, and Subsidiary are not in a partnership or joint venture with each other. They have never filed a partnership income tax return with respect to the ownership of the land that is the subject of this letter. Although, Corporation and Subsidiary are consolidated taxpayers, they operate separate businesses, retaining different employees. Although Corporation uses Shareholder's separate property in its cattle business, it pays regular fees for the right to do so. The parties do not carry on any joint business activity. Hereafter, Corporation, Shareholder and Subsidiary are together referred to as "Taxpayer" and the lands at issue, which they separately own, are collectively referred to as the "Ranch."

On Date 1, Taxpayer entered into a "Contract for Sale and Purchase of Stewardship Credits and Agreement to Create Rural Land Stewardship Regarding [the Ranch]" (the Contract), with Buyer, an unrelated individual in the land development business. Pursuant to the Contract, the parties agreed to create a rural land stewardship overlay on the Ranch in accordance with statutes of State Z. This action would include the elimination by Taxpayer of certain land use layers from about W acres of the Ranch pursuant to a separate SSA Credit Agreement (Credit Agreement) and granting a perpetual restrictive stewardship easement to County Y pursuant to a separate Stewardship Easement Agreement (Easement Agreement).1 These actions, which will impair the value of the Ranch, will amount to a legal inducement of County Y to grant stewardship credits (credits) that reflect the value of the property rights that Taxpayer permanently relinquishes. Buyer will purchase the credits pursuant to the Contract for the expected sum of $V (depending on the number of credits generated) from Taxpayer through a qualified intermediary (QI).

Taxpayer will structure this transaction as a like-kind exchange using a QI as defined by Section 1.1031(k)-1(g)(4)(iii) of the Income Tax Regulations. Taxpayer will comply in all other respects with the requirements of the QI safe harbor as outlined in Section 1.1031(k)- 1(g)(4). Among other things, that regulation requires that a taxpayer seeking exchange treatment to enter into an exchange agreement with a QI. Pursuant to that agreement, the QI "acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." See Section 1.1031(k)-1(g)(4)(iii)(B). The regulation also requires that the QI enter into an agreement with a person other than the taxpayer for the transfer of the relinquished property. The regulation specifically provides that this requirement may be satisfied if the rights of a party to the agreement (in this context, Taxpayer's rights in the Contract, the Credit Agreement and the Easement Agreement) are assigned to the QI and all parties to these agreements are notified in writing of the assignments, on or before the date of the relevant transfer of property. See Section 1.1031(k)-1(g)(4)(v).

More particularly, Taxpayer will assign its rights under the Contract to a QI before Taxpayer and County Y enter into the Credit Agreement and before Taxpayer, County Y and State Z's Department of Agriculture and Consumer Services enter into the Easement Agreement. Subsequent to that assignment, but prior to the closing, the Credit Agreement and the Easement Agreement will also be assigned to the QI. Each of these assignments will be made in the manner consistent with Section 1.1031(k)-1(g)(4)(v). By assigning its rights to the credits to the QI prior to the awarding of such credits, Taxpayer will not have actual or constructive receipt of the credits or the relinquished property proceeds.

Upon closing, Buyer will pay the relinquished property proceeds directly to the QI pursuant to these assignments and receive, in exchange therefor, the stewardship credits. These credits will entitle Buyer to develop real property it owns in a manner not permitted in the absence of the credits. Once Buyer pays the QI for the credits, the QI will use the money thus derived to acquire other real estate identified by Taxpayer as its replacement property.

Taxpayer and the QI will act in such manner as to insure full and timely compliance with the identification period and replacement period requirements set forth in Section 1031(a)(3)(A) and (B) (as well as Rev. Proc. 2000-37, 2000-2 C.B. 308, as applicable). Taxpayer held the relinquished property and will hold the replacement property for "productive use in a trade or business or for investment" as required by Section 1031(a)(1). As noted previously, Section 1.1031(k)-1(g)(4)(iii)(B) requires that the QI acquire and transfer the replacement property to Taxpayer. For this purpose, the QI will be treated as having acquired and transferred the replacement property if the QI enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to Taxpayer. Section 1.1031(k)-1(g)(4)(v) provides that a QI will be treated as having entered into an agreement (for the acquisition of replacement property) if the rights of a party to the agreement are assigned to the QI and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the replacement property. In this case, Taxpayer will identify one or more replacement properties, enter into agreements with the owners of such properties for their acquisition and, prior to the closings of such acquisition(s), assign its rights as purchaser under such agreements to the QI. Upon the closing of such acquisition(s), the QI will pay the seller(s) of the replacement property out of proceeds from the sale of the relinquished property and such sellers will convey title to the replacement property (or properties) directly to Taxpayer.

LAW AND ANALYSIS

Section 1031(a)(1) provides 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 1.1031(a)-1(b) provides, in part, that the words like kind refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

As examples of exchanges of property of like kind, Section 1.1031(a)-1(c) provides that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

A number of revenue rulings, three of which are summarized below, address the issue of the character of easements as real property. In Rev. Rul. 55-749, 1955-2 C.B. 295, land was exchanged for perpetual water rights, which are considered real property rights under the applicable state law. The ruling holds that the fee interest in the land and a water right in perpetuity are sufficiently similar to constitute property of like kind for purposes of Section 1031(a).

In Rev. Rul. 59-121, 1959-1 C.B. 212, the taxpayer granted an easement of indefinite duration over specified portions of its land. The grantee of the easement intended to construct a dam and reservoir on the land and to use of portions of the land for the deposit of industrial waste. While the taxpayer retained mineral rights and rights to otherwise enjoy the land and any buildings thereon, the taxpayer was prohibited from interfering with the easement granted. The revenue ruling provides that, since "the easement is with respect to land, it constitutes an interest in real property", and the proceeds derived from the sale of the easement constitute proceeds from the sale of an interest in real property.

Finally, Rev. Rul. 72-549, 1972-2 C.B. 472, provides that an easement and right-of-way granted to an electric power company are properties of like kind to both real property with nominal improvements and real property improved with an apartment building.

With respect to Taxpayer's ruling request, the stewardship easement will be in perpetuity and arises out of Taxpayer's interest in the underlying land. Such easements are also interests in real property under the laws of State Z. In effect, Taxpayer will exchange a perpetual stewardship easement for a fee simple interest in like- kind property in a deferred exchange, using the safe harbor provided under Section 1.1031(k)-1(g)(4). The steps in the transaction, to the extent outlined above, conform to the rules of that safe harbor. Therefore, we rule as follows:

1. A perpetual stewardship easement of the type described in the facts presented is of like kind to a fee interest in other real property; and

2. The use of the proceeds from the relinquished perpetual stewardship easement (i.e., the cash proceeds derived from the credits which are issued to Buyer through the QI by assignments in connection with Taxpayer's grant of such easement) to purchase one or more fee interests in real property to be held by Taxpayer for productive use in a trade or business or for investment will not disqualify the transaction from tax deferred exchange treatment under Section 1031.

CAVEAT(S)

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. Specifically, we express no opinion whether the proposed transaction qualifies in all other respects for tax deferral under Â§ 1031 beyond what is expressly stated in the above ruling. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200631012

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: August 4, 2006
April 13, 2006

Section 1031 -- Exchange of Property Held for Productive Use or Investment

LEGEND

Partnership =
Company =
LLC =
A =
B =
C =
D =
E =
F =
G =
Family =
Percent H =
Percent I =
Percent J =
Percent K =
Percent L =
Percent M =
Percent N =
Address 1 =
Address 2 =
City X =
City Y =

Dear***:

This is in reply to a letter dated July 22, 2004, and subsequent correspondence submitted on yourbehalf by your authorized representative requesting a private letter ruling on the applicability of section 1031 of the Internal Revenue Code of 1986 (Code) to the sale of certain cooperative apartments and the subsequent purchase of replacement properties.

STATEMENT OF FACTS:

Partnership is a partnership for federal income tax purposes. Company is an S corporation for federal income tax purposes. Both entities use the cash method of accounting and file their federal income tax returns on the calendar year.

A and D each own H percent of Partnership. B owns I percent of Partnership, and C owns J percent of Partnership. LLC owns K percent of Partnership. E and Family each own L percent of LLC. F and G each own M percent of Company, and E owns N percent of Company.
Partnership owns shares of stock in 21 cooperative apartments and 2 garage spaces at Address 1 in City X, which is located in New York State. Company owns shares of stock in 25 cooperative apartments at Address 2 in City Y, which is also located in New York State. Partnership and Company rent these properties and collect rental payments. All of the properties are owned by cooperative housing corporations organized under New York State law.

Partnership and Company intend to sell their interests in the above-described properties they now own. Partnership and Company have identified replacement properties consisting of improved and unimproved real properties to be received in transactions intended to qualify as like kind exchanges under section 1031. These replacement properties will be owned by Partnership and Company as tenants in common.
You have represented that Partnership and Company will comply with the 45-day identification period and the 180-day replacement period provided for in section 1031, as well as the rules governing the use of an intermediary to facilitate a like kind exchange. Accordingly, your letter ruling requests concern whether Partnership's and Company's interests in cooperative apartments in New York State will be considered like kind to the real property interests that Partnership and Company intend to acquire in the exchange.

STATEMENT OF LAW AND ANALYSIS:

Section 1031 of the Code provides for the nonrecognition of gain or loss in an exchange of properties that are held for productive use in a trade or business or for investment if such properties are exchanged solely for like kind properties that are held for productive use in a trade or business or for investment. A deferred exchange is an exchange wherein the property to be exchanged by the taxpayer is relinquished before the replacement property is acquired. Generally, a deferred like kind exchange utilizes an intermediary to hold the relinquished or acquired property before such property is transferred to the exchanging taxpayer.

If a taxpayer in a deferred like kind exchange actually or constructively receives money or non-like kind property before the taxpayer actually receives the replacement property, gain may be recognized on the exchange. Further, if a taxpayer in a deferred exchange actually or constructively receives money or non-like kind property in the full amount of the consideration for the relinquished property, then the transaction will constitute a taxable sale and not an exchange, even though the taxpayer may ultimately receive like kind replacement property. Treas. Reg. Â§1.1031 (k)-l(a).

To assist taxpayers in structuring like kind exchanges, the section 1031 regulations provide four safe harbors whereby taxpayers will not be in actual or constructive receipt of exchange proceeds in a deferred like kind exchange: security or guarantee arrangements, qualified escrow accounts andqualified trusts, qualified intermediaries, and interest and growth factors. Of these four, only the safe harbor for qualified intermediaries also provides a safe harbor against characterization of the accommodator facilitating the deferred exchange as an agent of the taxpayer.

Treas. Reg. Â§1.1031(k)-1(g)(4). The use of the qualified intermediary safe harbor further requires that the qualified intermediary not be considered a disqualified person with respect to the taxpayer involved in the exchange within the meaning of Treas. Reg. Â§1.1031(k)-1(k).

Treas. Reg. Â§l.1031(a)-1(b) defines like kind for purposes of section 1031 and explains that the term like kind has reference to the nature or character of the property and not to its grade or quality. Properties to be exchanged tax free under section 1031 must be of the same kind or class. With respect to real estate, Treas. Reg. Â§1.1031 (a)-l(b) states that whether the real estate is improved or unimproved is not material because that relates only to the grade or quality of the property and not to its kind or class.

Treas. Reg. Â§1.1031(a)-1(c) sets forth examples of properties that will be considered like kind. The most relevant examples pertain to real estate and provide that a taxpayer who is not a dealer in real estate may exchange city real estate for a ranch or farm, a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate.

Whether stock in a cooperative apartment located in New York State constitutes real or personal property under section 1031 is determined under New York law. See, e.g., Rev. Rul. 55-749, 1955-2 C.B. 295. Although New York case law might suggest that there are conflicts concerning whether a cooperative interest in real property is real property (State Tax Comm'n v. Shor, 43 N.Y.2d 151,371 N.E.2d 523, 400 N.Y.S.2d 805 (1977), questioned in In re Pandeff, 201 B.R. 865 (Bankr. S.D.N.Y. 1996)), various New York statutes treat an interest in a cooperative as equivalent to an interest in real property. N.Y. Civ. Prac. L.& R. Â§ 5206(a) (McKinney 1997) (homestead exemption); N.Y. Real Prop. Law Â§ 279(5) (McKinney 1989) and N.Y. Pub. Auth. Law Â§ 2402(5) (McKinney Supp. 2006) (mortgage for cooperative interest); N.Y. Real Prop. Tax Law Â§ 467(3-a) (McKinney Supp. 2006) (real property tax for senior citizens); N.Y. Tax Law Â§ 1402-a(a) (McKinney 2004) ("mansion tax"); and N.Y. Real Prop. Law Â§ 254-b(1) (McKinney 1989) (limit on mortgage late charges).

CONCLUSION

Accordingly, we rule that the interests in cooperative apartments in New York owned by Partnership and Company will be considered like kind, for purposes of section 1031, to the improved and unimproved real property that Partnership and Company intend to acquire as replacement properties. The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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.

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 taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 11.04 of Rev. Proc. 061, 2006-1 I.R.B. 1,49. However, when the criteria in section 11.07 of Rev. Proc. 06-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

William A. Jackson Branch Chief, Branch 5
(Income Tax & Accounting)

PRIVATE LETTER RULING 200404044

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: January 23, 2004
October 23, 2003

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Taxpayer =
State =
Aquifer =

Dear ***:

This responds to your letter, dated July 16, 2003, requesting a ruling on whether water rights are of like-kind with a fee simple interest in farm land under Section 1031 of the Internal Revenue Code.

FACTS:

Taxpayer is an individual farmer engaged in the business of farming. Taxpayer owns a right to pump ground water from Aquifer for irrigation purposes and specified tracts of land. Taxpayer's water rights are limited to a maximum diversion rate of 1,100 gallons per minute and a maximum quantity of 195 acre-feet of water per calendar year. The water rights are not limited in duration, but State retains the authority to make reasonable reductions in the diversion rate and the quantity pumped as may be deemed to be in the public interest. Taxpayer proposes to exchange the water rights to a third party for additional farm land. According to Taxpayer, the transaction will be structured to meet all of the section 1031 requirements to achieve a tax-free exchange.

Taxpayer requests a ruling that the proposed exchange of water rights for farm land constitutes an exchange of like-kind property within the meaning of section 1031 of the Code.

LAW:

Section 1031(a)(1) 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 that is to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) of the Income Tax Regulations defines like-kind as referring to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only or the grade or quality of the property and not to its kind or class.

Section 1.1031(a)-1(c)(2) provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.
In Rev. Rul. 55-749, 1955-2 C.B. 295, land was exchanged for perpetual water rights that are considered real property rights under the applicable state law. This revenue ruling holds that the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of like-kind property within the meaning of section 1031.

Rev. Rul. 68-331, 1968-1 C.B. 352, holds that a leasehold interest in a producing oil lease extending until the exhaustion of the deposit is of like-kind to a fee interest in an improved ranch under section 1031 of the Code because both the leasehold interest and the fee interest are continuing interests in real property.

In Wiechens v. United States, 228 F. Supp. 2d 1080 (D. Az. 2002), the taxpayers conveyed water rights for a fee interest in farm land. The taxpayer's water rights were limited in duration to a 50-year period, limited in quantity to a specific percentage of the overall supply of agricultural water, and limited in priority to be secondary to municipal, industrial and Indian uses. The District Court refused to equate the taxpayer's water rights to a 30-year leasehold interest. The Court held that the application of section 1031 "requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike." Factors to be considered in this analysis include "the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, [and] the duration [of the interests]." Id. at 1085 (citing to Koch v. Commissioner, 71 T.C. 54, 65 (1978)). The Court found that because the taxpayer's water rights were narrowly restricted in priority, quantity, and duration, although the taxpayer's water rights constituted an interest in real property, the water rights were not sufficiently similar to the fee simple interest that it acquired in the farm land to qualify as like-kind property.

Under the regulations cited, the types of real estate interests that are within the same kind or class as fee interests in real estate is broad. Both revenue rulings cited demonstrate that perpetual easements in the form of water rights and an interest in a producing oil lease extending until the exhaustion of the deposit belong to the same kind or class of property as a fee interest in real estate.

In the present case, Taxpayer is exchanging water rights for a fee interest in farm land. Taxpayer's water rights are a perpetual interest in real property under applicable state law. Unlike Wiechens, the water rights are limited in quantity to a specified amount per year rather than limited in quantity to a specific percentage of the overall supply of agricultural water.

Accordingly, based upon the representations submitted and the above analysis, the water rights owned by Taxpayer are of like-kind under section 1031 to the fee simple interest in the replacement farmland, provided that the properties are held for productive use in a trade or business or for investment.

No determination is made by this letter as to whether the described transaction otherwise qualifies under section 1031 as an exchange of property for which Taxpayer will recognize no gain or loss.

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 taxpayer(s) 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.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

Sincerely,

J. Charles Strickland
Senior Technician Reviewer, Branch 5
Office of Income Tax and Accounting Division
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200203042

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: January 18, 2002
October 18, 2001

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Taxpayer =
Con Org =
Old Ranch =
New Ranch =
Family Group No. 1 =
Family Group No. 2 =
Family Group No. 3 =
StateX =
Citation X =

Dear ***:

This responds to the letter written in your behalf, dated January 26, 2001, requesting a ruling on the proper treatment of an exchange, under Section 1031 of the Internal Revenue Code, of a Perpetual Conservation Easement (PCE) in real property for a fee interest in other real estate that will also be burdened with a PCE upon receipt.

These are the applicable facts:

Taxpayer is a member, along with one other entity, of Family Group No. 2. The two entities comprising Family Group No. 2, along with the entities comprising Family Group No. 1 and Family Group No. 3, are co-owners of the fee interest in Old Ranch in State X.

Family Group No. 1 (including Taxpayer) operates a cattle ranching business on Old Ranch through a limited liability company (LLC). Family Group Nos. 2 and 3 lease their respective undivided interests in Old Ranch to LLC for grazing of cattle. In addition, the co-owners of Old Ranch have formed a general partnership (GP) under state law to perform routine maintenance on Old Ranch. However, GP does not hold any interest in Old Ranch and will not own any interest in property to be received in the planned exchange. All of Old Ranch, consisting of approximately 11,500 acres, is used for cattle ranching purposes except for approximately 6 acres used for personal residences.

Taxpayer and other co-owners wish to engage in a like-kind exchange with ConOrg, a Section 501(c)(3) organization. Under an agreement entered into by Taxpayer and the other co-owners with ConOrg, Taxpayer and the other co-owners will convey a PCE on the Old Ranch to ConOrg in exchange for the fee estate of New Ranch, in State X, which will also be burdened with a PCE when received by Taxpayer and the other co-owners.

The planned transaction will be a simultaneous, two-sided exchange (i.e., involving no accommodation parties, third party sellers of replacement property or third party buyers of relinquished property). Following the exchange, New Ranch will be held by Taxpayer and the other co-owners in the exact same proportions as the interests they now hold and will retain in Old Ranch burdened with the PCE.

The State X Civil Code provides at Citation X.1 that the purpose of a conservation easement is to retain land predominately in its natural, scenic, historical, agricultural, forested, or open space condition. Citation X.2 provides that a conservation easement is an interest in real property voluntarily created and freely transferable in whole or in part for the purposes stated in Citation X.1 by any lawful method for the transfer of interest in real property in State X. Citation X.2 further provides that a conservation easement shall be perpetual in duration and shall constitute an interest in real property notwithstanding the fact that it is negative in character.

Section 1031(a)(1) of the Code 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(b) states that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1.1031(a)-1(b) of the Income Tax Regulations provides that, as used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Section 1.1031(a)-1(c) of the regulations, as an example, provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.

Rev. Rul. 55-749, 1955-2 C.B. 295 holds that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of Section 031(a).

Rev. Rul. 72-549, 1972-2 C.B. 472, holds that an easement and right-of-way, which were permanent, granted to an electric power company, were properties of like kind with real property with nominal improvements and real property improved with an apartment building.

Under the regulations cited, the types of real estate interests that are within the same kind or class as fee interests in real estate is broad. Both revenue rulings cited demonstrate that perpetual easements in the form of water rights and right-of-ways are of the same kind or class of property to which a fee interest in real estate belongs. The PCE at issue is also an easement. Under State X law, a PCE is an interest in real estate which, like a fee, is of a perpetual nature.

Therefore, based upon the above authorities and the facts and representations submitted, and assuming the proposed PCE is, by virtue of state law, an interest in real property, Taxpayer's exchange of a PCE in real property, under Section 1031(a), for a fee interest in other real estate that is also subject to a PCE will qualify as a tax deferred exchange of like-kind property, provided that the properties are held for productive use in a trade or business or for investment. If Taxpayer receives money or other nonlike-kind property in the exchange, gain will be recognized to the extent of the such money received and the fair market value of such other property. Also, Taxpayer (and each of the co-owners) must recognize whatever gain is realized with respect to the fair market value of the replacement property received attributable to the transfer of the PCE as to that portion of the Old Ranch used for residential purposes and not for use in a trade or business or for investment.

No determination is made by this letter as to whether the described transaction otherwise qualifies for deferral of gain realized under Section 1031. Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. No opinion is expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling.

Under the Power of Attorney Form 2848 on file with this office, we are sending this original letter to you and a copy to your representative stated on line 2 of the form.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.

Sincerely yours,

Robert M. Casey
Acting Chief, Branch 3
Office of Associate Chief Counsel (Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200203033

Date: October 18, 2001

Taxpayers =
Con Org =
Old Ranch =
New Ranch =
Family Group No. 1 =
Family Group No. 2 =
Family Group No. 3 =
StateX =
Citation X =

Dear
This responds to the letter written in your behalf, dated January 26, 2001, requesting a ruling on the proper treatment of an exchange, under § 1031 of the Internal Revenue Code, of a Perpetual Conservation Easement (PCE) in real property for a fee interest in other real estate that will also be burdened with a PCE upon receipt. These are the applicable facts:

Taxpayers are members, along with other persons, of Family Group No. 3. The persons comprising Family Group No. 3, along with the entities comprising Family Group No. 1 and Family Group No. 2, are co-owners of the fee interest in Old Ranch in State X.

Family Group No. 1 operates a cattle ranching business on Old Ranch through a limited liability company (LLC). Family Group Nos. 2 and 3 lease their respective undivided interests in Old Ranch to LLC for grazing of cattle. In addition, the co-owners of Old Ranch (including Taxpayers) have formed a general partnership (GP) under state law to perform routine maintenance on Old Ranch. However, GP does not hold any interest in Old Ranch and will not own any interest in property to be received in the planned exchange. All of Old Ranch, consisting of approximately 11,500 acres, is used for cattle ranching purposes except for approximately 6 acres used for personal residences of some of the co-owners.

Taxpayers and other co-owners wish to engage in a like-kind exchange with ConOrg, a § 501(c)(3) organization. Under an agreement entered into by Taxpayers and the other co-owners with ConOrg, Taxpayers and the other co-owners will convey a PCE on the Old Ranch to ConOrg in exchange for the fee estate of New Ranch, in State X, which will also be burdened with a PCE when received by Taxpayers and the other co-owners.

The planned transaction will be a simultaneous, two-sided exchange (i.e., involving no accommodation parties, third party sellers of replacement property or third party buyers of relinquished property). Following the exchange, New Ranch will be held by Taxpayers and the other co-owners in the exact same proportions as the interests they now hold and will retain in Old Ranch burdened with the PCE.

The State X Civil Code provides at Citation X.1 that the purpose of a conservation easement is to retain land predominately in its natural, scenic, historical, agricultural, forested, or open space condition. Citation X.2 provides that a conservation easement is an interest in real property voluntarily created and freely transferable in whole or in part for the purposes stated in Citation X.1 by any lawful method for the transfer of interest in real property in State X. Citation X.2 further provides that a conservation easement shall be perpetual in duration and shall constitute an interest in real property notwithstanding the fact that it is negative in character.

Section 1031(a)(1) of the Code 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(b) states that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1.1031(a)-1(b) of the Income Tax Regulations provides that, as used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Section 1.1031(a)-1(c) of the regulations, as an example, provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.

Rev. Rul. 55-749, 1955-2 C.B. 295 holds that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of § 1031(a).

Rev. Rul. 72-549, 1972-2 C.B. 472, holds that an easement and right-of-way, which were permanent, granted to an electric power company, were properties of like kind with real property with nominal improvements and real property improved with an apartment building.

Under the regulations cited, the types of real estate interests that are within the same kind or class as fee interests in real estate is broad. Both revenue rulings cited demonstrate that perpetual easements in the form of water rights and right-of-ways are of the same kind or class of property to which a fee interest in real estate belongs. The PCE at issue is also an easement. Under State X law, a PCE is an interest in real estate which, like a fee, is of a perpetual nature.

Therefore, based upon the above authorities and the facts and representations submitted, and assuming the proposed PCE is, by virtue of state law, an interest in real property, Taxpayers' exchange of a PCE in real property, under § 1031(a), for a fee interest in other real estate that is also subject to a PCE will qualify as a tax deferred exchange of like-kind property, provided that the properties are held for productive use in a trade or business or for investment. If Taxpayers receive money or other nonlike- kind property in the exchange, gain will be recognized to the extent of the such money received and the fair market value of such other property. Also, Taxpayers (and each of the co-owners) must recognize whatever gain is realized with respect to the fair market value of the replacement property received attributable to the transfer of the PCE as to that portion of the Old Ranch used for residential purposes and not for use in a trade or business or for investment.

No determination is made by this letter as to whether the described transaction otherwise qualifies for deferral of gain realized under § 1031. Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. No opinion is expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling.

Under the Power of Attorney Form 2848 on file with this office, we are sending this original letter to you and a copy to your representative stated on line 2 of the form.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.

Sincerely yours,

ROBERT M. CASEY
Acting Chief, Branch 3
Office of Associate Chief Counsel
(Income Tax & Accounting)

PRIVATE LETTER RULING 200137032

Date: June 15, 2001
Refer Reply To: CC:IT&A:5 PLR-109211-01

LEGEND:

Taxpayer = ***
Apartment = ***
YCorp = ***

DEAR ***

This responds to your letter dated February 5, 2001, and subsequent submissions, requesting a ruling on the proper treatment of an exchange of an interest in a cooperative apartment unit, (which includes shares of stock in a residential cooperative corporation owning and operating the cooperative and the building and common areas where the cooperative apartment unit is located, and an interest as a tenant in a long-term proprietary lease to the same premises set to expire in the year 2036) for a condominium interest in fee in the same apartment and common areas under section 1031 of the Internal Revenue Code. Specifically, you are requesting a ruling that Taxpayer shall not recognize any gain or loss from the exchange of such interests. These are the applicable facts:

Taxpayer is a New York stock corporation, which presently owns shares of stock and proprietary leases to residential cooperative apartments in various buildings in New York City. One such property held by Taxpayer as a shareholder and proprietary lessee is Apartment. This property is owned and operated by a cooperative housing corporation, YCorp, which is also organized as a New York stock company. Taxpayer and all other shareholders and proprietary lessees of YCorp have the right to occupy their respective apartments and they have the obligation to pay their proportionate share of the cost of operating the property. The current proprietary leases are long-term leases, all having more than 30 years remaining to their terms. Taxpayer has hold Apartment (the proprietary lease for Apartment) for more than two years.

YCorp will file a condominium declaration pursuant to the Condominium Act of the State of New York. Taxpayer (along with each of the shareholders and proprietary lessees) may exchange its interest in the building operated by YCorp for a condominium deed for the same apartment without other consideration. Upon the recording of the condominium deed, the unit owner will be responsible for the payment of its proportionate share of the common charges, as well as for the real estate taxes which will be separately assessed against the particular unit. The condominium will operate Apartment and all other apartments in the condominium in precisely the same manner as the cooperative is now operated.

Section 1031 of the Code provides 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 1.1031(a)-1(b) of the Income Tax Regulations provides that the words like kind have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

Section 1.1031(a)-1(c) of the regulations provides examples of exchanges of property of a "like kind." It states that no gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.
State law is usually determinative as to whether an interest in property constitutes real or personal property and, therefore, whether the property interest in question, is amenable to a tax deferred exchange for other real property under section 1031 of the Code. For example, the Service holds in Rev. Rul. 55-749, 1955-2 C.B. 295, that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property under section 1031(a) of the Code provided the requirements of that section as to holding for productive use in a trade or business or for investment are satisfied.

The legal status of stock ownership in a cooperative in the State of New York as real property or personal property is unclear. See e.g., State Tax Commission v. Shor, 43 N.Y. 2d 151, 154 (1988); and AHL Properties Ten v. 306-100th St. Owners Corp., 86 N.Y.2d 643 (1995). However, under various New York statutes, stock ownership in a cooperative is often treated and equated as an interest in real property.[1] Moreover, the condominium deed will constitute a fee interest to the same underlying real property, to the same common areas and particularly to Apartment, (the same apartment). The only difference will be that Taxpayer will hold title to Apartment directly by condominium deed rather than indirectly as a shareholder in a cooperative corporation and proprietary lessee.

Accordingly, as to Taxpayer, we rule that directly held legal title to Apartment evidenced by a condominium deed is of like kind to Taxpayer's interest in the same Apartment as shareholder in the present owner of Apartment (the cooperative corporation) and proprietary lessee of such Apartment.

The Taxpayer's presently held interest as tenant, and the condominium to be received in the exchange, are both real property interests representing the same physical property for purposes of section 1031 of the Code. Therefore, the exchange of Taxpayer's leasehold interest in the Apartment for a

condominium interest in the same property constitutes a nontaxable exchange of properties of a like-kind under section 1031(a), provided that the properties are held for productive use in a trade or business or for investment and all other requirements for deferral under section 1031 are satisfied.

No determination is made by this letter as to whether the described transaction otherwise qualifies for deferral of gain realized under section 1031. Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. No opinion is expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.

Sincerely yours,

Associate Chief Counsel
(Income Tax & Accounting)
By: Robert M. Casey
Senior Technician Reviewer,
Branch 5

PRIVATE LETTER RULING 8810034

Dec. 10, 1987

This is in reply to a letter dated August 5, 1987, submitted on behalf of the Partnership, requesting rulings that a proposed transaction qualifies as a like-kind exchange under section 1031 of the Internal Revenue Code.

The information submitted indicates that Partnership holds interest in a parcel of real estate and several multi-unit apartment buildings located on the real estate. The apartment buildings are owned by the Partnership under two forms of ownership: (1) some of the land and apartment units are owned in a fee simple, and (2) some of the land and apartment units are part of a stock cooperative organized under the laws of State X known as the "Cooperative".

At the time the Cooperative was created, it entered into proprietary leases for a term of ninety-nine (99) years (the "Leases") with each of its shareholders. Each of the leases has in excess of 92 years remaining in the term, and all of the leases, representing all of the units owned by the Cooperative, have been assigned to the Partnership by the previous owners. In addition, the Partnership owns all of the membership shares in the Cooperative.

In order to obtain refinancing more readily, and to ease the administrative difficulties encountered in operating the units, the Partnership proposes to exchange its ownership interest in the cooperative apartment units for direct ownership of the real estate in a condominium form or as a fee simple interest. The exchange would occur through the liquidation of the cooperative and the exchange of the Partnership's cooperative stock and interest in the proprietary leases for the condominium interest received in liquidation.

Section 1031(a) of the Code provides that no gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stocks, bonds, notes, choses in action, certificates of trust or beneficial interest and certain other types of property not here pertinent) is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(c) of the Income Tax Regulations provides, in part, that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges a leasehold of a fee with 30 years or more to run for real estate.

Rev. Rul. 55-749, 1955-2 C.B. 295, holds that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property under section 1031(a) of the Code provided the requirements of that section as to holding for productive use in a trade or business or for investment are satisfied.

Given the unique nature of tenant-stockholder's interest, consisting of leasehold rights linked with stock ownership, it is an oversimplification to regard the tenant-stockholder as merely a stockholder with an interest in the realty (see 15A Am Jur 2d, CONDOMINIUMS AND CO-OPERATIVE APARTMENTS,section 78 (1976)), and it is, therefore, incorrect to regard a tenant-stockholder's interest as falling within the parenthetical language of section 1031(a) excluding stocks, choses in action, certificates of beneficial interest, etc. from favorable treatment under that provision. In the present case, because the tenant-stockholder's interest includes a lease the term of which exceeds 30 years (See section 1.1031(a)-1(c) of the regulations, SUPRA) and because this interest is characterized as a real property interest under state law (See IN RE PITTS' ESTATE, 218 Cal. 184, 22 P. 2d 694 (Cal. 1933), cited with approval in CALIFORNIA COSTAL COMMISSION V. QUANTA INVESTMENT CORPORATION, 170 Cal. Rptr. 263, 113 Ca. App. 3d 579 (Cal. Ct. of Appeal 1980)) the tenant-stockholder's interest should be characterized as a real property interest for purposes of section 1031. See Rev. Rul. 55-749, SUPRA, as to the effect of state law in characterizing property interests for purposes of section 1031. Compare Rev. Rul. 66-40, 1966-1 C.B. 227, in which the Internal Revenue Service relied on New York law in holding that the interest held by a taxpayer in a New York cooperative apartment is not considered real property for purposes of section 2515(a) of the Code. Moreover, the California statute (West's Ann. Cal. Civ. Code, Section 783) and Rev. Rul. 77-423, 1977-2 C.B. 352, treat a condominium interest as the ownership of real property.

Section 1250(a) of the Code provides for ordinary income treatment with respect to a portion of the gain from the disposition of certain depreciable real property. For purposes of section 1250, a leasehold of land is considered real property. Section 1.1250-1(e)(3) of the regulations.

Section 1250(d)(4) of the Code provides, in part, that where property is disposed of and gain is not recognized in whole or in part under section 1031, then the amount of gain treated as ordinary income under section 1250(a) shall not exceed the greater of (i) the amount of gain recognized on the disposition increased by the amount determined under section 1033(a)(2)(A) or (ii) the excess of the gain taken into account under section 1250(a) over the fair market value of the section 1250 property acquired in the transaction.

The Partnership's presently held interest as tenant-stock-holder, and the "condominiums" to be received in the exchange, are both real property interests representing the same physical property. Therefore, the surrender of Partnership's stock in Cooperative in exchange for a condominium interest in the same property constitutes a nontaxable exchange of properties of a like-kind under section 1031(a), provided that the properties are held for productive use in a trade or business or for investment.

The basis in the "condominiums" received by Partnership will be determined under section 1031(d) of the Code. The holding period of the "condominiums" received by Partnership will include Partnership's holding period in the stock of cooperative held as tenant-stockholder, provided Partnership's interest as a tenant-stockholder was a capital asset or property described in section 1231. See section 1223(1) of the Code.

Because Partnership will not recognize gain under section 1031 of the Code, Partnership will not treat any gain as ordinary income under section 1250(a) of the Code. See section 1250(d)(4).

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Except as specifically ruled on above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Code.

GENERAL COUNSEL MEMORANDUM 39606

Internal Revenue Service (I.R.S.)
General Counsel Memorandum
Date Numbered: February 27, 1987
February 8, 1987

Section 61 — Gross Income v. Not Gross Income
Section 74 — Prizes and Awards
Section 165 — Deductions For Losses
Section 167 — Depreciation
Section 263 — Capital Expenditures (Deductible v. Not Deductible)
Section 1031 — Exchange of Property Held for Productive Use or Investment
Section 1221 — Capital Asset v. Not a Capital Asset
Section 1223 — Holding Period of Capital Assets
Section 1231 — Property Used in the Trade or Business and Involuntary Conversions (Capital Gain v. Ordinary Income Treatment)

Section 1231.00-00 Property Used in the Trade or Business and Involuntary Conversions (Capital Gain v. Ordinary Income Treatment)

Peter K. Scott
Associate Chief Counsel (Technical)
Attention: Director, Corporation Tax Division

By memorandum dated May 20, 1986, you informed us of a request from the United States Department of Transportation (DOT) for an explanation of the Federal income tax consequences of the sale or exchange of airplane takeoff and landing rights, or 'slots', at certain high-density airports. This request was prompted when the Federal Aviation Administration (FAA), a part of the DCT, instituted a 'buy/sell rule', effective on April 1, 1986, under which commercial airlines and other 'persons' are permitted to purchase, sell, lease, and trade their allocated slots at these airports. Most existing slots were allocated to their current holders ('incumbents') under a 'grandfather' provision. Some existing slots and newly-available slots will be allocated to new entrants and others in periodic lotteries.

You have requested our opinion on a number of issues raised by this buy/sell development. Our discussion will be restricted to the tax consequences under the Internal Revenue Code prior to its amendment by the Tax Reform Act of 1986, Pub. L. No. 99-514.

ISSUES

1. Is the fair market value of a slot includible in an airline's gross income under section 61 of the Code as a result of its initial acquisition from the FAA by an 'incumbent' airline, its receipt from the FAA in a lottery, or the institution of the buy/sell rule?

2. Must the costs of acquiring a slot be capitalized under section 263 of the Code? If so, may such costs be depreciated under section 167 of the Code?

3. Is income or loss from the use or disposition of a slot ordinary or capital in character?

4. Can gain or loss realized in a slot-for-slot trade qualify for nonrecognition under the 'like-kind exchange' provisions of section 1031 of the Code?

5. Can the reversion of a slot give rise to a loss deduction under section 165 of the Code? If so, is the loss ordinary or capital?

CONCLUSIONS

1. As in similar cases involving certain government-created rights and privileges, the initial acquisition of a slot from the Federal government--whether by grandfathering an incumbent, by lottery, or by some other method--is not an event that results in the realization of gross income. Nor would the government's action in creating a market for airport slots, as of April 1, 1986, be a taxable event with respect to incumbent slot-holders.

2. A slot is a separate and distinct income producing intangible asset with an indefinite useful life, that is capable of being bought, sold, leased, or traded. The purchase price or other costs of acquiring a slot must be capitalized as part of the cost basis of the slot. These costs may not be recovered through a depreciation deduction, but only on abandonment or other disposition. In the case of a purchase of a slot along with other assets for a lump sum, an appropriate portion of the purchase price must be allocated to the slot.

3. Income from the use of a slot in commercial passenger airline operations is, of course, ordinary income.

Income from the 'lease' of a slot, as permitted by the FAA, would be ordinary in nature.

The character of gain or loss from the disposition of a slot depends on whether a slot is a 'capital asset' under section 1221 of the Code (or a 'quasi-capital asset' under section 1231); whether the transaction qualifies as a 'sale or exchange' under section 1222 (or 1231); and the length of the taxpayer's 'holding period' under sections 1222 and 1223.

In our opinion, a slot may, as a preliminary matter, come within the scope of the definition of a section 1221 'capital asset'. It is 'property' within the meaning of section 1221. Even though used in a taxpayer's trade or business, it would not be excluded from 'capital asset' status by section 1221(2),

since it is neither depreciable nor real property. (By the same token, it cannot qualify as 'property used in the trade or business' under section 1231(b)).

Depending on the circumstances, a slot may be excluded from 'capital asset' status under section 1221(1) if held by a dealer. This possibility is enhanced by the FAA's intentional inclusion of non-airlines as 'persons' capable of acquiring slots.

Moreover, a taxpayer (such as a commercial airline) that uses a slot in its business could be viewed as realizing ordinary gain or loss from the sale of a slot by virtue of the judicial doctrine established in Corn Products Refining Co. v. Commissioner, 350 US 46 (1955). However, since the precise scope of the Corn Products doctrine is unclear, and there is a conflict among the circuit courts as to the basic scope of the Corn Products doctrine, with the distinct possibility of impending Supreme Court resolution of such conflict, we cannot at this time specify whether this doctrine would apply to the disposition of airport slots.

If, in a given case, a slot qualifies as a section 1221 capital asset, established principles would apply in determining whether the 'sale or exchange' requirement is met. Also, the holding period for incumbents, in our view, would commence some time prior to the FAA institution of the buy/sell rule, when the slot was first acquired under the prior allocation system. Further factual development would be required to establish the exact date.

4. A slot-for-slot trade may qualify as a nonrecognition transaction under section 1031. Unless, in a given situation, a slot constitutes 'stock in trade or other property held primarily for sale', it would not be excluded from nonrecognition treatment by the exceptions in section 1031(a)(2). Two slots used for commercial air traffic are of 'like kind' whether they are for different times, or at different airports, or both.

5. Under the buy/sell rule, a slot may be forfeited pursuant to a 'use-or-lose' provision, or withdrawn for one of several reasons. Either event could give rise to a loss deduction under section 165 in the amount of the taxpayer's basis in the slot. This assumes there is a closed and completed transaction on the facts of the particular case.

The character of the loss, whether it resulted from forfeiture or withdrawal, would normally be ordinary either because the slot was not a capital asset in the taxpayer's hands, or because of the lack of a 'sale or exchange'.

FACTS

In the late 1960's, congestion became a problem at several large metropolitan airports in the United States. This congestion was a function of several factors, including noise pollution restraints and limits on runway space, airspace, ground facilities, passenger terminal capacity, and air traffic control capacity. The Secretary of Transportation and the FAA have broad authority to regulate and control the use of the navigable airspace of the United States, in order to ensure its efficient utilization and the safety of aircraft. See sections 307(a) and (c) of the Federal Aviation Act of 1958 ('the FAA Act'), 49 USC section 1348(a) and (c). In 1968, the FAA issued a 'High Density Traffic Airports Rule', restricting the hourly number of takeoff and landing slots available at Kennedy, O'Hare, LaGuardia, Washington National and Newark airports. The rule establishes quotas on the number of IFR reservations per hour that will be accepted during certain hours of the day at these airports, based on the overall IFR capacity of the airport. Slots are allocated among three general classes of airport users: scheduled commercial air carriers, scheduled air taxis (commuter airlines), and all other operators--primarily general aviation but also charter operators.

The high density rule did not specifically provide a means of allocating slots to individual operators within each class. For commercial air carriers and commuter operators, this allocation was generally accomplished through the operation of eight 'scheduling committees' composed of incumbent operators and interested new entrants at each airport. Operating under a limited grant of antitrust immunity, these committees allocated slots through a voluntary bargaining process.

In the late 1970's the FAA became increasingly dissatisfied with the functioning of the scheduling committees, which were subject to delays and deadlocks. These problems were exacerbated by the increased demand for slots following the Airline Deregulation Act of 1978, 92 Stat. 1705, which phased out the functions of the Civil Aeronautics Board (CAB) in limiting the number of airlines that could service particular cities. Beginning in 1980, the FAA began considering alternatives to the scheduling committee system, including lotteries, auctions, and administrative allocation procedures.

On December 16, 1985, the DOT issued the current 'buy/sell' rule, amending the regulations under 14 CFR Parts 11 and 93 to authorize the transfer, for consideration, of slots at the four high- density airports. The rule applies only to the commercial air carrier and commuter slot pools. Initial acquisition of slots under the 'buy/sell' rule was accomplished by allowing each operator holding a permanent slot as of December 16, 1985, under the prior committee allocation system, to continue holding the slot. 14 CFR section 93.215(a). A small percentage of slots were reallocated in a lottery, in which new entrants had preference.

Effective April 1, 1986, the rule permits commercial air carriers, commuters, and other 'persons' to buy, sell, or lease slots for any consideration and for any time period, and allows trading of slots in any combination for slots at the same or another airport. 14 CFR section 93.221(a). The FAA intended slot ownership to be open to non-aviation entities such as banks, communities, and brokers to ensure that slots go to their most productive use. Transfers must be reported to and confirmed by the FAA, but confirmation will normally be automatic, unless the transfer would be injurious to the 'essential air services' (EAS) program. A certain number of slots are reserved for international and EAS flights; transfer of these slots is restricted to one-for-one intra-airport trades.

In certain circumstances a slot may revert to the FAA under the new regulations. First, under a 'use-or-lose' provision, any slot not used 65 percent of the time over a 2-month period will revert. Exceptions are made for strike and bankruptcy situations. 14 CFR section 93.227. Second, slots may be withdrawn at any time to fulfill operational needs, such as providing slots for international or EAS flights or eliminating slots. 14 CFR section 93.223. The regulations state: 'Slots do not represent a property right but represent an operating privilege subject to absolute FAA control.' 14 CFR section

93.223(a). It is not expected that the FAA will need to exercise its withdrawal authority except in extraordinary circumstances. The order in which slots will be recalled if withdrawal is necessary will generally be determined by each slot's 'withdrawal priority', established in lotteries conducted at the outset of the program. This withdrawal priority is an attribute of the slot that survives transfer to another owner or FAA reallocation. 14 CFR section 93.223.

The FAA will allocate or reallocate newly-available slots by means of periodic lotteries in which new entrants have preferences. Only air operators (i.e., not all 'persons') are eligible to obtain slots in this manner. 14 CFR section 93.225.

An operator using a slot it is not entitled to use is subject to a #1,000 maximum civil penalty for each unlawful takeoff or landing. 14 CFR section 93.229(a).

Since the buy/sell rule became effective, there has been considerable activity in slot sales. As of June 17, 1986, the FAA had confirmed 30 sales involving 96 slots. According to a DOT official, slots are worth $225,000 on the average, and the purchase price for some slots has been estimated at $1 million.

At this writing, bills are pending in both the House and Senate to repeal the buy/sell rule. Opponents say the rule allows private companies to profit from the sale of public assets.

ANALYSIS

ISSUE 1. INCOME ON INITIAL ACQUISITION FROM GOVERNMENT.

The threshold question raised in this case is whether a taxpayer realizes gross income for income tax purposes when it first acquires a slot from the FAA, or when a slot it holds is made transferable for consideration pursuant to the buy/sell rule.

Section 61 defines gross income as 'income from whatever source derived', except as otherwise provided by law. See Treas. Reg. 1.61- 1(a). Gross income includes income realized in any form, whether in money, property, or services. Id. This definition encompasses all 'accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.' Commissioner v. Glenshaw Glass Co., 348 US 426, 431 (1955).

In the present case, the exclusive landing or takeoff privileges that make up a 'slot' are clearly of significant value in producing income from airline operations, and the FAA's action in making slots transferable for consideration has enhanced that value. This benefit is derived from the Federal government. However, there is no general provision exempting Federal benefits from taxation. See, e.g ., Babocuivari Cattle Co. v. Commissioner, 135 F2d 114 (9th Cir. 1943) (government subsidies to cattle rancher taxable); Rev. Rul. 60- 32, 1960-1 CB 23, considered by this office in * * *, GCMs 29925/31036, A-622275 (March 11, 1957/Dec. 15, 1958) (Department of Agriculture payments and cost-sharing benefits under Soil Bank Act taxable). Although slots were not acquired in return for specific past or future services rendered to the government, that fact in itself does not prevent taxation under Glenshaw Glass and other established precedents.

However, in a wide variety of instances, the creation of property rights similar to the slots in issue, under an assortment of federal, state, and local licensing and other regulatory schemes, has not caused the recipient of such rights to be in receipt of gross income. This is true even though, in some cases, these rights are transferable, have an ascertainable fair market value, and were acquired at no cost or for a negligible fee. Rev. Rul. 67-135, 1967-1 CB 20, for example, holds that the difference, if any, between the fair market value and the cost of an oil and gas lease obtained by a taxpayer in a 'lottery' conducted by the United States Bureau of Land Management is not includible in the gross income of the leaseholder under section 61 at the time the lease is obtained.

In addition to such direct authority, there is indirect evidence for this proposition in many cases and rulings that discuss the tax treatment of the costs of acquiring government-created privileges, with respect to such issues as capitalization, depreciation, and loss. In these cases and rulings, a taxpayer who has acquired such an asset by purchase from a third party will have a basis in that asset corresponding to the purchase price. When the asset was acquired directly from a government entity, however, the basis in the asset will either be zero or will be made up of certain fees and related expenditures incurred in acquiring or defending the license or other right. Had the difference between these costs, if any, and the fair market value of the asset been taxed on acquisition, however, this difference would have been added to the taxpayer's basis. Cf. Treas. Reg. 1.61-2(d)(2)(i).

In Rev. Rul. 56-520, 1956-2 CB 170, for example, considered in * * *, A-618734, the Service considered the treatment of legal, engineering, and accounting fees and other expenditures incurred with respect to a contest, before the Federal Communications Commission, to determine whether the taxpayer should be awarded permission to use a certain channel for television broadcasting. The ruling holds, in part, that if the taxpayer succeeds, the expenditures must be capitalized as part of the cost of a nondepreciable intangible asset. There is no indication that the acquisition of this obviously valuable exclusive privilege is a taxable event.

The same inference can be drawn from Rev. Rul. 64-124, 1964-1 CB 105, Radio Station WBIR v. Commissioner, 31 TC 803 (1959), and Richmond Television Corp. v. United States, 345 F2d 901 (4th Cir.), rev'd and remanded on another issue, 382 US 68 (1965) (TV and radio broadcast licenses and permits); Rev. Rul. 56-600, 1956-2 CB 171, considered in * * *, GCM 29291, A-618003 (Feb. 6, 1956), and Rev. Rul. 67-113, 1967-1 CB 55, considered in * * *, GCMs 31143/33423, A-625853 (Mar. 13, 1959/Jan. 25, 1967) (CAB air route certificates); Rev. Rul. 67-141, 1967-1 CB 153, Rev. Rul. 83- 137, 1983-2 CB 41, and Nicolazzi v. Commissioner, 79 TC 109 (1982), aff'd per curiam, 722 F2d 324 (6th Cir. 1983) (oil and gas leases, consistent with Rev. Rul. 67-135); Rev. Rul. 70-644, 1970-2 CB 167, modified in Rev. Rul. 72-384, 1972-2 CB 479, clarified in Rev. Rul. 73-429, 1973-2 CB 304, revoked, but only in narrow circumstances, in Rev. Rul. 75-466, 1975- 2 CB 74, considered in 'Class I' Milk Bases in the Puget Sound, GCM 36420, I-3485 (Sept. 15, 1975) ('milk bases' entitling a producer to sell milk at a premium price under a Federal milk marketing order have a tax basis 'if purchased'); Rev. Rul. 66-58, 1966-1 CB 186, considered in Upland Cotton Allotment, I-2033 ('upland cotton acreage allotments' under Federal law); Nachman v. Commissioner, 191 F2d 934 (5th Cir. 1951), aff'g, 12 TC 1204 (1949) (city liquor licenses, cited in Rev. Rul. 56-520); Shufflebarger

v. Commissioner, 24 TC 980 (1955), and Uecker v. Commissioner, 81 TC 983 (1983), aff'd per curiam, 766 F2d 909 (5th Cir. 1985) (Federal and state cattle grazing privileges, including renewable permits, leases and licenses). See also Standby Gasoline Rationing Plan, GCM 38237, I-3-80 at 3 (Jan. 10, 1980) (proposed transferable gas rationing coupons); * * *, GCM 37971, I-55- 78 at 6-7 (June 1, 1979) (milk base created under private rather than governmental scheme).

The intangible assets considered in these cases and rulings share with airport landing rights the characteristic of having been conferred by a governmental body in furtherance of government regulatory policies in allocating a limited resource. They may permit the holder to obtain 'monopolistic' or 'quasi-monopolistic' benefits. Yet, the determination in each of these situations has obviously been made that the value of such governmental licenses and permits will be taxed only as, and if, the taxpayer realizes that value through use or disposition.

We find no basis for distinguishing the landing rights in this case from the other governmental privileges just discussed. When an incumbent operator first obtained its slot under the pre-1986 scheduling committee system, that event was no different, in essence, from the acquisition of a CAB air route, an FCC broadcast channel, a milk marketing area milk base, or a county upland cotton acreage allotment. Nor do we think that the institution of the buy/sell rule changed the nature of grandfathered rights so markedly as to be considered a taxable event--either in December 1985, when incumbents first knew that their slots would be marketable, or on April 1, 1986, the actual effective date of such rule. The milk bases and cotton acreage allotments were marketable to third parties, but that fact did not cause the holders of those rights to be in receipt of gross income until such government created rights were disposed of to third parties. Finally, the fact that certain slots have been and will continue to be awarded in a lottery does not require their inclusion in income. Cf. Rev. Rul. 67-135, supra.

ISSUE 2. TREATMENT OF ACQUISITION EXPENDITURES.

Another issue you have raised is the proper treatment by the transferee of the price of a purchased slot (or, in the case of a slot acquired from the government, fees or other expenditures, if any, related to the acquisition).

The first question under this heading is whether these expenditures may be expensed when paid or incurred, or whether they must be capitalized. Generally, an expenditure must be capitalized under section 263 if the expenditure creates, enhances, or is part of the cost of acquiring or defending a tangible or intangible asset with a useful life greater than one year. Commissioner v. Lincoln Savings & Loan Ass'n, 403 US 345 (1971). A slot is an intangible asset the useful life of which, in terms of generating income, extends well beyond the taxable year. Expenditures related to the acquisition of a slot therefore fall squarely within section 263.

The second question is whether these capitalized costs may be recovered in advance of sale or other disposition of the slot through a deduction for depreciation. Under Treas. Reg. 1.167(a)-3, if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. . . . An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation.

Most of the cases and rulings cited above under Issue 1 for their indirect implications with respect to income are directly in point on both the capitalization and depreciation questions. As discussed above, for example, Rev. Rul. 56-520 and the Richmond Television case call for the capitalization of various fees and expenses associated with the acquisition of broadcast rights, and go on to disallow a deduction for depreciation.

The right to take off or land at a certain time at a certain airport is not an asset with a determinable useful life. Under the buy/sell regulations, slots are not periodically reallocated, nor are they subject to periodic renewal or review by the government. This feature was intentional. The DOT believed that a market in permanent slots would permit long-range stability in carrier planning and marketing. Cf. Note, Airline Deregulation and Airport Regulation, 93 Yale L. J. 319, 331 (1983) (advocating a market in slots of finite duration). [FN10] In this respect, the case against the expensing or depreciation of slot acquisition costs is even stronger than in many of the cases and rulings cited above, in which periodic renewal of the rights in question was required, and yet the asset was still found to have an indefinite useful life because of the probability of renewal. See, e.g., Nachman, supra, 191 F2d at 935. Compare Rev. Rul. 67-113, supra (discussing the proper treatment of a variety of expenditures relating to 'temporary' and 'permanent' CAB air route certificates), with Van De Steeg v. Commissioner, 60 TC 17 (1973), aff'd per curiam, 510 F2d 961 (9th Cir. 1975) ('milk base' depreciable when milk marketing plan had a specific termination date). See also Rev. Rul. 75-466, supra (limiting Van De Steeg to a particular milk base marketing area).

Neither the fact that the regulations do not purport to create a property interest, nor the possibility that a slot might revert to the FAA in certain circumstances justifies the expensing or depreciation of slot acquisition expenditures. (As discussed under Issue 5 below, however, such a reversion may form the basis for a loss deduction under section 165). To cite an analogy, the FA Act, 49 USC section 1371(i), provides: 'No certificate shall confer any proprietary, property, or exclusive rights in the use of any air space, federal airway, landing area, or air navigation facility', and a certificate is revocable in the public interest. Yet the Service does not permit expensing or depreciation of acquisition costs for air route operating certificates. Rev. Rul. 56-500, supra. The forfeiture of a slot under the 'use-or-lose' provision in the buy/sell rule is an event essentially within the taxpayer's control. The possible withdrawal of a slot for operating reasons, like the possible adjustment or termination of the grazing preferences considered in the Shufflebarger case, see 24 TC at 995, is a contingency that is not geared to any period or the passage of time, and that may never happen.

We recognize that both the FAA and the airline industry are making efforts to alleviate congestion at the affected airports. Such factors as increases in airport capacity, technological developments, changes in the industry, etc., may lead at some point in the future to the elimination of slot constraints at some or all of the high density airports. Given the fact that these slot constraints have already been in effect for 18 years, however, and the fact that the FAA intentionally made slots infinite in duration under the buy/sell rule, we can find no basis at this point in time for a finding that a slot has a useful life of definite duration. In fact, according to testimony on June 17, 1986 by the American Association of Airport Exeutives before the Aviation Subcommittee of the U.S. House of Representatives Committee on Public Works and Transportation, FAA officials have recently projected that by 1990, 32 airports will require some slot constraints, and that by the year 2000, 61 airports will require some slot constraints. These projections

certainly do not support a contention that slots have a useful life that can be estimated with reasonable accuracy. In fact, these agency projections indicate that slot constraints will probably be with us for the foreseeable future, and thus clearly have an indefinite and undeterminable useful life.

We have not addressed in this discussion exactly how a taxpayer would arrive at the proper basis for a slot in a given case. Questions could arise, for example, as to whether specific expenditures are sufficiently related to the acquisition of a slot to warrant capitalization. See, e.g., Richmond Television, supra, and related cases. In addition, although determining the basis of a purchased slot could be straightforward in many cases, this may not be true when, for example, a slot is acquired along with other slots or assets fr a lump sum. Beyond stating that in the latter case the transaction should be fragmented and an appropriate portion of the purchase price allocated to the slot, [FN11] these issues must be left for later development or case-by-case determination.

ISSUE 3. ORDINARY/CAPITAL CHARACTER OF INCOME FORM USE OR DISPOSITION OF SLOTS.

Since, at least under present law, the characterization of income or loss as either 'ordinary' or 'capital' can be crucial in determining the tax consequences for both individual and corporate taxpayers, an important issue in the present case is how income or loss from the use or disposition of airport slots will be treated.

It is obvious that an airline's use of a slot in its normal passenger operations will generate ordinary income. In addition, receipts from the 'lease' of a slot, as permitted by the regulations under the buy/sell rule, will be ordinary income to the lessor. The more difficult characterization issues arise on the sale or other disposition of all or some portion of a slot.

At the outset, we should note that under the buy/sell rule, taxpayers have considerable flexibility in structuring transactions in slots. The rule permits, for example, co-ownership of slots. It is our understanding that the rules would allow a situation in which one operator would use a given slot on certain days of the week, while a different operator would use it on the remaining days. In this discussion, however, we will focus on a simple hypothetical situation in which a taxpayer holding a slot transfers the entire slot to another party in return for a lump-sum cash payment.

Under the current law, the capital or ordinary character of gain or loss from the disposition of an asset depends on whether the asset is a 'capital asset' under section 1221 (or an asset described in section 1231), and whether the transaction qualifies as a 'sale or exchange' under section 1222 (or section 1231). The length of the taxpayer's 'holding period' under sections 1222, 1223, and 1231(b)(1) may also be significant in determining whether the transaction results in 'long-term' or 'short-term' capital gain or loss.

a. CLASSIFICATION AS 'CAPITAL ASSET'.

Section 1221 defines the term 'capital asset' as 'property held by the taxpayer (whether or not connected with his trade or business)'. Under sections 1221(1) through 1221(5), certain specified types of property are expressly excluded from being a capital asset. In addition to these 'statutory exclusions', capital asset status has been denied for certain types of assets under several judicial theories, the most notable of which was established in Corn Products Refining Co. v. Commissioner, 350 US 46 (1955).

(1) A SLOT AS 'PROPERTY'.

Before discussing the enumerated statutory exclusions and the Corn Products doctrine, we will address two related judicial theories that sometimes deny section 1221 capital asset treatment.

The first is that an item that might be viewed as property in some other context is not 'property' as that term is used in section 1221. An example of this approach, as well as a statement of the general policy considerations and rule of construction concerning the term 'capital asset', is found in Commissioner v. Gillette Motor Transport, Inc., 364 US 130 (1960). In Gillette, a taxpayer argued that compensation paid by the United States for temporary seizure of its business facilities during World War II was taxable as capital gain because the seizure was a taking of its 'property' under the just compensation clause of the Fifth Amendment. The Supreme Court held that neither the taxpayer's right to use its premises nor its right to be compensated for the temporary taking of its premises constituted 'property' within the meaning of the statutory predecessor to section 1221. The Court stated:

It is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year

364 US at 134. The Court reasoned that the government 'took' only the right to use the underlying property for a temporary period, a right in which the taxpayer had no investment (and no basis) separate and apart from its investment in the underlying physical assets themselves. The compensation received by the taxpayer for the government's right to use the taxpayer's property was rent, and thus represented ordinary income to the taxpayer.
Another aspect of the same basic approach to the 'capital asset' definition is represented in such cases as Commissioner v. P.G. Lake, Inc., 356 US 260 (1958), and Hort v. Commissioner, 313 US 28 (1941). These cases stand for the proposition that Congress meant to exclude from 'capital asset' status rights to present or future income when the cash or other consideration for the transfer of those rights represents nothing more than a 'substitute' for income that would have been taxable to the transferor at ordinary rates had the transfer not been made.

Both the Gillette and P.G. Lake lines of reasoning have been recognized and employed in numerous cases. See, e.g., Commissioner v. Ferrer, 304 F2d 125 (2d Cir. 1962) (receipts from transfer of motion picture and dramatic rights by actor/producer); Foy v. Commissioner, 84 TC 50 (1985) (franchise rights). In determining whether contract rights should be considered 'property' within the meaning of sections 1221 and 1231, the courts have considered a variety of factors, including whether the rights are incident to, or create an estate in, specific real or personal property that is itself a

capital asset, see Ferrer, supra; whether the transferred rights represent an interest that can appreciate in value over a period of years as the result of market forces, see Estate of Shea v. Commissioner, 57 TC 15 (1971), acq., 1973-2 CB 3; whether significant investment risks were associated with the transferred rights and included in the transfer, see Foy, supra; whether a market and a market price exists for the rights, see Ferrer; whether the rights primarily represented compensation for past or future personal services, id.; whether the taxpayer parted with the totality of its rights, or 'carved out' a portion in some fashion, see P.G. Lake, supra; whether the rights originated with the seller or purchaser, see Ferrer; and whether it is possible to assign a specific basis to the transferred rights, see Gillette, supra.

In the present case, the 'bundle of rights' represented by a slot can be viewed as comprising several elements. One salient element is the right to use the slot: i.e., the right to take off or land every day at a particular time at a particular airport for a commercial purp se. This right to use could be further broken down into different aspects, such as a right to occupy runway space, a right to use the navigable airspace of the United States at a particular time, a right to air traffic control and other airport services, a right to generate a certain amount of noise pollution, etc. The slot-holder also has the right to exclude others from interfering with these privileges. Not only can the slot-holder seek the imposition of a $1,000 penalty by the FAA for unauthorized use of a slot, but in addition it seems highly unlikely that, as a practical matter, unauthorized use could continue for long in such a heavily-regulated environment.

Under both pre-1986 and post-1986 FAA regulations, the holder of a slot has the right to transfer the slot in exchange for a different slot. Under the buy/sell rule, a slot carries with it the right to lease and a right to sell or otherwise transfer a slot subject to minimal restrictions. Under the pre-1986 rules a slot could only be transferred for consideration as part of a transfer of the business as a going concern. Under the buy/sell rule, a slot may be transferred by itself or in combination with other assets, and it is not necessary to be an actual carrier or have any other investment in, or connection with, an airport in order to hold or transfer a slot. Although the government may withdraw a slot, an individual slot carries with it a certain withdrawal priority right. Finally, subject to the 'use-or- lose' and withdrawal contingencies, the foregoing rights are permanent under the regulations. In terms of the factors identified in Ferrer and the other cases discussed above, we believe that the 'bundle of rights' represented by an entire slot qualifies as 'property' within the meaning of sections 1221 and 1231. While a holder's rights in a slot do not represent an interest in some other specific property, they are themselves valuable, transferable rights enforceable through civil penalties. A slot is an interest that can fluctuate in value over a period of years, and the value of a slot when a transfer is made would not be attributable to any specific past or future efforts on the part of the transferor. The rights inherent in such a transferred slot do not originate with either the seller or the purchaser. Assuming that a taxpayer parts with an entire slot instead of carving out a portion limited in time or in some other fashion, the transferor has parted permanently with all operating and economic privileges associated with that slot, and has shifted the investment risks to the transferee. Such a taxpayer has not simply substituted one source of ordinary income for another. Finally, we view a slot as a discrete asset, representing an investment severable from such other assets as an operator's terminal facilities, other slots, or the particular air route for which a slot is used. [FN13]

The regulations under the buy/sell rule state that slots do not represent a property right but only an operating privilege subject to absolute FAA control. In our view, this does not prevent the transfer of a slot from one holder to another from being treated as a sale of 'property' for Federal income tax purposes. This statement in the FAA regulations is intended to address the status of slots in certain non- tax legal contexts. For example, whether an individual has 'vested rights' in government benefits may be significant in determining if certain procedural restrictions apply as a matter of constitutional or administrative law when those rights are withdrawn or modified. See, e.g., Northwest Airlines, Inc. v. Goldschmidt, 645 F2d 1309, 1321 (8th Cir. 1981). There has also been litigation concerning whether an airport slot is 'property' under certain provisions of the Bankruptcy Code. See, for example, In re Braniff Airways, Inc., 700 F2d 935, 942 (5th Cir. 1983), in which the court, as an alternative ground for its holding that the bankruptcy court had no jurisdiction to order the transfer of the bankrupt's slots, held that the landing slots were not 'property' of the bankrupt's estate under 11 USC section 105, since '[t]he slots are actually restrictions on the use of property-- airplanes; not property in themselves.' Accord, In re Air Illinois, Inc ., 53 BR 1 (Bankr. SD Ill. 1985); contra, In re American Central Airlines, InC., 52 BR 567, 571 (Bankr. ND Iowa 1985) ('Although the FAA may remove a slot at any time, until such action is taken, the holder has a possessory interest in a slot at the given airport').

Whatever significance the FAA's regulation may have in these non- tax contexts, and whatever significance it may have when the issue is the tax treatment of transactions with the government, we do not believe that the presence or absence of vested property rights vis-a- vis the government is controlling in determining whether transactions between third parties are dealings in 'property' under the Internal Revenue Code. As discussed above under Issue 2, this factor is not controlling in determining whether capitalization is required or depreciation allowed.

The conclusion that an airport slot may qualify as 'property' under sections 1221 and 1231 is buttressed by analogy to the tax treatment of similar exclusive privileges created by governmental action. Rev. Rul. 66- 58, supra, holds that an upland cotton acreage allotment--representing the right to certain price support payments and loans for cotton grown on alloted acreage under the Agricultural Adjustment Act of 1938--is an intangible property right that qualifies as a capital asset under section 1221, if held by a taxpayer who is not a dealer in such allotments. See also Rev. Rul. 70-248, supra (California liquor business license); Rev. Ruls. 70-644 and 75-466, supra (holding, together, that outside of certain narrow circumstances, 'milk bases' under several specific Federal and state milk marketing orders qualify as section 1221 capital assets).

(2) INVESTORS IN SLOTS.

Given that an airport slot is 'property' under section 1221, classification of an airport slot as a 'capital asset' may still depend on the holder's motives and the way in which the slot is used-- whether, for example, a particular holder is an investor in slots, a dealer in slots, a user of slots, or combines these roles in some fashion.

If an airport slot is held solely for investment, any gain or loss would be capital in nature under section 1221. Cf. Rev. Rul. 73- 428, 1973-2 CB 303 (royalty interest in oil and gas held for investment is a capital asset). The fact that the FAA has broadened the class of slot-holders to include non-airline 'persons' raises this possibility.

Given the 'use-or-lose' provision, a non-airline would not be able to hold a slot for any significant length of time without leasing it, which might in some circumstances raise an issue as to whether such a holder was in the trade or business of leasing slots. See, e.g., Fackler v. Commissioner, 133 F2d

509, 511-12 (6th Cir. 1943). Such a finding would put the holder in the same category as an airline slot-holder, insofar as it would raise the section 1221(2) and Corn Products issues discussed below.

(3) DEALERS IN SLOTS UNDER SECTION 1221(1).

Another possibility, for both airline and non-airline slot- holders, is that the circumstances of a given case may indicate that the taxpayer is a dealer in slots, falling under the statutory exclusion in section 1221(1). Section 1221(1) excludes from 'capital asset' status stock in trade, inventory, and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Here again, the FAA's action in making slots readily transferable and making non-airlines potential transferees raises the possibility that a particular slot-holder may be a dealer under section 1221(1). Cf. Rev. Ruls. 66-58 and 70-644, supra.

(4) SLOT USERS: SECTIONS 1221(2) 1231, AND THE 'CORN PRODUCTS' DOCTRINE.

In the majority of cases, of course, airport slots will probably continue to be held by actual commercial airline operators. Section 1221(2) excludes from the definition of a capital asset a taxpayer's property that is 'used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business.' Although depreciable property and real property held for business use are thus excluded from capital asset status under section 1221, such assets are entitled to preferential treatment under section 1231 if they are held for more than six months. See IRC 1231(b)(1). Section 1231 provides generally for capital gain or ordinary loss treatment on the sale or exchange of such assets, depending on the outcome of netting computations involving the aggregate gains and losses for the tax year from such sales or exchanges and certain involuntary conversions of assets.

In our opinion, an airport slot used in a taxpayer's trade or business is not excluded from the definition of a 'capital asset' by section 1221(2), since a slot is not depreciable; as discussed above under Issue 2, and is not real property. For the same reason, a slot cannot qualify as depreciable or real 'property used in the trade or business' as that term is defined in section 1231(b)(1).

The finding that a slot is not 'real property' within the meaning of sections 1221(2) and 1231(b)(1) merits further discussion. For section 1231 purposes, 'real property' includes enforceable interests in real property, such as leaseholds, Rev. Rul. 72-85, 1972-1 CB 234 considered in * * *, GCM 34649, I-615 (Oct. 19, 1971); oil and gas leases and royalties, Rev. Ruls. 68-226, 1968-1 CB 362, and 73-428, supra; easements, Rev. Rul. 59-121, 1959-1 CB 212, considered in * * *, GCM 30186, A-623501/A-623508 (July 30, 1957); water rights, Rev. Rul. 73-341, 1973-2 CB 306; and 'transferable development rights' in agricultural property, Rev. Rul. 77- 414, 1977-2 CB 299, considered in * * *, GCM 36405, I-184-75 (Sept. 8, 1975). Cf. Rev. Rul. 71-286, 1971-2 CB 263 (air rights).

Although, at first impression, it might seem that a airport slot bears a resemblance to some of these interests, it is clear that the holder of a slot has no enforceable interest in any specific real property. A slot grants permission to occupy a runway and/or the navigable airspace of the United States for a certain purpose at a certain time (in addition to the right to air traffic control and other support facilities, the right to generate a certain amount of noise in the vicinity of the airport, etc.). However, such revocable license rights are no more an interest in real property than a state driver's license is an interest in the state roads over which one may drive.

Under section 1221, a 'capital asset' includes property held by the taxpayer 'whether or not connected with his trade or business'. Since, with respect to property used in a taxpayer's trade or business, section 1221(2) excludes only real property and depreciable property, the statutory language creates a presumption that NONdepreciable, PERSONAL property used in the trade or business, other than property covered by sections 1221(1), (3), or (4), qualifies as a section 1221 capital asset. This presumption is strengthened by the general balance sheet treatment of such items as land, franchises, licenses, customer lists, or purchased goodwill with no definite useful life as capital assets representing long-term investments that may appreciate in value, even though also used to produce income in the normal course of business. On this basis, a slot acquired by an airline for use in its trade or business would seem to fall within the scope of the term 'capital asset' in section 1221.

There is analogous support for this conclusion in the rulings and cases discussed above holding that such intangible, nondepreciable assets as liquor licenses, 'milk bases', and cotton acreage allotments are capital assets, even though used as an essential part of the taxpayer's trade or business. Rev. Rul. 66-58, for example, holding that a cotton acreage allotment is a section 1221 capital asset if held by a taxpayer who is not a dealer, states that 'it would generally be necessary for a taxpayer engaging in the business of growing and selling upland cotton to have an upland cotton acreage allotment.' 1966-1 CB at 186-87. See also, Rev. Rul. 70-248, 1970-1 CB 172, with respect to the capital asset character of a renewable state liquor license; Rev. Rul. 70-644, supra, 1970-2 CB at 168, with respect to the section 1221 capital asset status of certain 'milk bases'. There is also an analogy to such privately-created intangible assets as franchises, which may be section 1221 capital asset even though they are used in the trade or business and may be nondepreciable. See, e.g., Rev. Rul. 71-123, 1971-1 CB 227 (professional football franchises); Foy v. Commissioner, 84 TC 50 (1985) (professional janitorial services franchises). See also S. Rep. No. 552, 91st Cong., 1st Sess. at 207-10 (1969), reprinted in 1969-3 CB 423, 554- 56 (discussing the history and purpose of section 1253 of the Code, added in 1969 to specify the tax treatment of most franchise, trademark, and trade name transfers). The capital gain treatment generally accorded goodwill is also analogous, in the sense that goodwill can be viewed as a nondepreciable intangible asset used in the trade or business.

Capital asset treatment for intangible nondepreciating personal property used in a trade or business (and not described in any of the other enumerated statutory exclusions) is also consistent with the legislative history of sections 1221(2) and 1231. From 1921, when Congress first distinguished between capital and ordinary gains, until 1938, when the predecessor to section 1231 was enacted, the definition of a capital asset included all property used in a trade or business (i .e., that was not stock in trade, inventory, or primarily held for sale in the ordinary course of business). In the Revenue Act of 1938, 52 Stat. 500, Congress excluded 'depreciable property used in a trade or business' from the definition of a capital asset. The reason was to allow losses from the sale of depreciable assets to be deducted in full against ordinary income. Land used in the trade or business, however, was still subject to capital treatment. See H. Rep. No. 1860, 75th Cong ., 3d Sess. 7-8 (1938), reprinted in 1939-1 (Part 2) CB 728, 732-33.

In 1942, Congress created the predecessor to current section 1231 by providing that gains on depreciable property used in the trade or business, held for a certain period, should generally be taxed as capital gains, although losses on such assets would remain ordinary. At this point, land used in a trade or business, though nondepreciable, was excluded from the 'capital asset' definition and included with depreciable real estate improvements under the predecessor to section 1231. See S. Rep. No. 1631, 77th Cong., 2d Sess. 49-50 (1942), reprinted in 1942-2 CB 504, 545. There was no indication in either 1938 or 1942 that nondepreciable personal property used in the trade or business should not continue to be treated as a capital asset, where no other statutory exclusion is applicable.

However, the mere fact that property used in the trade or business falls outside the specific statutory exclusion in section 1221(2) does not render gain or loss from its sale immune from treatment as ordinary in nature. In Corn Products Refining Co. v. Commissioner, 350 US 46 (1955), the Supreme Court affirmed a lower court finding that a taxpayer's acquisition and sale of corn futures were an integral part of the everyday operations of the taxpayer's business, and held that transactions in those corn futures gave rise to ordinary gain or loss, rather than capital gain or loss, because the corn futures were not capital assets in the hands of the taxpayer. The Court in Corn Products construed the term 'capital assets' narrowly to effectuate the congressional purpose of the capital gains provisions of the Code, stating:

Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by section 117 [the predecessor of section 1221] applies to transactions in property which are not the normal source of business income. . . . Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. . . . This Court has always construed narrowly the term 'capital assets' in section 117. 350 US at 52.

Since 1955, the judicial doctrine created in the Corn Products decision has been applied in a wide range of situations, involving both gain and loss, different types of assets, occassional or even one-time as well as recurring transactions, and a variety of business motives, such as ensuring a source of supply or a position as supplier, acquiring the business expertise and experienced personnel of an acquired corporation, maintaining a position as an employee or corporate officer, or protecting a business reputation. See Campbell Taggart, Inc. v. United States, 744 F2d 442 (5th Cir. 1984), and cases discussed therein.

No clear-cut test for determining when the Corn Products principle will apply has emerged from the case law. In Booth Newspapers, Inc. v. United States, 303 F2d 916, 921 (1962), which involved the purchase of stock of a paper mill company to assure the taxpayer-purchasers a supply of newsprint at a time when there were serious shortages of such paper, the Court of Claims expressed what has sometimes been termed the 'business/investment purpose' test (now generally applied), and some of the factors considered under that test:

If securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.

Thus, the circumstances of the transaction (its factual background, the necessities of the particular business involved at the particular time involved, and the intentions of the taxpayer, both at the time the securities were originally purchased and at the time they were disposed of) are of crucial importance in the resolution of these cases.

This focus on the business versus investment motive of the taxpayer was further refined in a significant Tax Court decision, W. W. Windle Co. v. Commissioner, 65 TC 694 (1976), APPEAL DISMISSED, 550 F2d 43 (1st Cir. 1977), cert. denied, 43 U.S. 966 (1977). In Windle, the Tax Court ruled that when a taxpayer's motives for acquiring and holding stock are mixed, that is both business and investment, gain or loss on disposition will be capital in nature if the taxpayer had a 'substantial investment motive', even though the taxpayer also had a predominant business motive, for acquiring or continuing to hold the stock. The Windle test has been adopted by the Government, at least as applied to stock, see Rev. Rul. 78-94, 1978-1 CB 58, and by at least one circuit court, see Wright v. Commissioner, 756 F2d 1039 (4th Cir. 1985).

A review of cases and rulings involving the characterization of non-stock assets used in a trade or business, but not covered by section 1231, does not furnish a conclusive answer as to whether the Corn Products principle would or would not apply to the disposition of airport slots owned by a commercial operator. COMPARE, for example, Rev . Rul. 66-58, supra (cotton acreage allotments), Caboara v. Commissioner, TC Memo 1977-355, 36 TCM (CCH) 1420 (liquor licenses), Rev. Rul. 70-644, supra (milk base), and Foy v. Commissioner, supra, 84 TC at 66 (franchises), all of which suggest that Corn Products would not apply to the disposition of airport slots--WITH Norton v. United States, 551 F2d 821 (Ct. Cl. 1977) (ordinary income on sale of contract right to cut timber on U.S. Forest Service land), and Becker Warburg Paribas Group, Inc. v. United States, 514 F. Supp. 1273 (ND Ill. 1981) (ordinary loss on sale of seat on New York Stock Exchange), which suggest that Corn Products would apply to the disposition of airport slots.

To further complicate the analysis, a recent opinion by the Eighth Circuit Court of Appeals has resulted in a clear split in the circuits concerning the scope of the Corn Products doctrine. In Arkansas Best Corp. v. Commissioner, 800 F2d 215 (8th Cir., Sept. 9, 1986), rev'g on this issue, 83 TC 640 (1984), the court held that loss on the sale of a holding company's stock in a bank resulted in a capital loss, on the ground that business/investment intent is irrelevant under section 1221 and Corn Products should not be extended beyond its facts. In adopting this rationale the court went beyond the Government's argument, which was based on Windle and Rev. Rul. 78-94, and placed itself squarely in opposition to most other courts, which have used some form of business/investment motive analysis in applying Corn Products.

Moreover, the Eighth Circuit's decision in Arkansas Best seems to be clearly in conflict with the Fifth Circuit's decision in Campbell Taggart, Inc. v. United States, 744 F2d 442 (1984), another case involving a holding company's sale of stock. In Campbell Taggart, the Fifth Circuit held that loss on the sale of stock acquired to preserve the taxpayer's business reputation was ordinary in nature, on the ground that stock is entitled to ordinary asset

treatment when there is no investment purpose and it was acquired as an indirect means of incurring otherwise deductible business expenses. See id. at 451.

In view of this conflict between the circuits and possible Supreme Court review of the Arkansas Best decision, we believe that, apart from noting the potential for the Corn Products doctrine to apply to the disposition of airport slots, the Service is not in a position at this time to give a definitive answer concerning the general application of the doctrine in the different factual settings in which the slot disposition issue might arise.

b. THE 'SALE OR EXCHANGE' REQUIREMENT.

In order for gain or loss on a section 1221 capital asset to qualify for treatment as capital rather than ordinary, it must result from a 'sale or exchange' of that asset. See IRC 1222. The 'sale or exchange' requirement has been interpreted as encompassing a narrower class of transactions than is covered by the term 'sale or other disposition' in section 1001(a). Helvering v. William Flaccus Oak Leather Co., 313 US 247 (1941).

The 'sale or exchange' requirement has sometimes been the focus of controversy when intangible assets are transferred in situations indicating that the transaction is, in substance, a license or lease. Such questions may arise, for example, when the consideration for the transfer is contingent on the transferee's sales or profits from the transferred property, when the transferee parts with rights in certain geographical areas or fields of use only, or when the transferor retains control rights in the transferred asset. See, e.g., Resorts International, Inc. v. Commissioner, 60 TC 778 (1973), aff'd in part and rev'd in part, 511 F2d 107 (5th Cir. 1975) (retail paint store 'franchises'). In many contexts, the 'sale or exchange' issue is now governed by specific statutory provisions. See, e.g., IRC 1235 (patents); IRC 1253 (franchises, trademarks, and trade names).

No specific statutory provision would apply to airport slot transactions, and the 'sale or exchange' requirement might well become an issue in a particular case. However, we would regard the 'sale or exchange' requirement as having been clearly satisfied in the basic hypothetical situation that we are focusing on in this discussion: i.e., the absolute transfer of an entire individual slot for a lump sum . We would not view such an arrangement as some form of license or sublicense.

c. HOLDING PERIOD.

Section 1222 classifies capital gain or loss as 'short-term' or 'long-term' depending on whether the capital asset has been held for more than 6 months at the time of its sale or exchange. Section 1223 provides for the 'tacking' of holding periods in certain cases in which there is an 'exchange' of assets and the taxpayer's basis carries over from the transferred asset to the asset received (because gain or loss is not recognized on the transaction). The 'short- term/long-term' classification has significant consequences in determining the extent of preferential treatment under sections 1201, 1202 and 1211.

In Curtis v. United States, 336 F. Supp. 672 (WD Wash. 1972), the issue was when the holding period began for the taxpayers 'milk base' under a federal milk marketing order applicable to the Puget Sound, Washington, area. The government argued that the holding period began in September 1967, when a new 'Class I Base Plan' went into effect. The taxpayers maintained that it began in February 1967, when they received their allotment under the old plan. The court held for the government on the theory that the September 1967 regulatory action had extinguished the taxpayers' previous rights and created a new asset, and that there had been no 'exchange' that would permit the tacking of holding periods under section 1223. The key factor in the court's decision was that the September 1967 order provided for the first time that 'milk bases' could be transferred separately from a producer's dairy herd.

The Curtis 'two-asset' theory was not followed, however, in Rev. Rul. 73- 416, 1973-2 CB 304, and Rev. Rul. 73-429, 1973-2 CB 305, both considered in * * * / Class I Milk Bases, Puget Sound, Washington, GCMs 35208/35392, I-4852/I-3485 (Jan. 24, 1973/July 6, 1973). Rev. Rul. 73- 416, for example, holds that a producer's holding period for a California 'Class I milk production base' and 'milk pool quota' began on the day following the date those rights were originally acquired under the California Agricultural Code of 1933, despite the fact that subsequent legislation, the Gonsalves Pooling Act, permitted the producer to dispose of production base and pool quota separately from the producer's other dairy business assets. Rev. Rul. 73-416 states that '[t]here was no termination of existing rights and the creating of new rights wholly independent of the old rights provided under the Agricultural Code of 1933.' 1973-2 CB at 305.

In the present case, an airline that held a permanent slot prior to December 1985 was generally entitled to retain that slot under the buy/sell rule. Both before and after the institution of the rule in December 1985, such an incumbent slot-holder's underlying operating and economic rights remained substantially the same and stemmed from the same underlying legislative authority. In our view, neither the fact that the mechanics of slot allocation where changed, cf. Rev. Rul. 73-429, nor the fact that slots were made transferable separately from the rest of an airline's business assets, cf. Rev. Rul 73-416, compels a conclusion that an incumbent lost one asset and received a new asset when the buy/sell rule went into effect.

The holding period for an incumbent's slot would therefore begin the day after it received the slot under the scheduling committee allocation system in effect prior to the institution of the buy rule, rather than on December 17, 1985 or April 2, 1986.

Issue 4. SLOT TRADES AS 'LIKE-KIND EXCHANGES'.

The buy/sell rule expands the possibilities, already available to some extent under the prior scheduling committee system, for trading in slots. This raises the question whether gain or loss realized in a slot-for-slot trade may qualify for nonrecognition under the 'like- kind exchange' provisions of section 1031. Under section 1031(a)(1) of the Code, no gain or loss is recognized if property held for productive use in a trade or business or for investment 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(a)(2) excepts certain types of property from nonrecognition treatment, including (A) stock in trade and property held primarily for sale; (B) stocks, bonds, or notes; (C) other securities or evidences of indebtedness or interest; (D) partnership interests; (E) certificates of trust or beneficial interests; or (F) choses in action.

Just as an airport slot qualifies as 'property' under section 1221, as discussed above, we believe it falls within the scope of the term 'property' as used in section 1031(a). Although section 1031 is perhaps most often applied to exchanges of tangible real property, it may apply to intangible personal property, such as the slots at issue here, as well. See, e.q., Rev. Rul. 71-137, 1971-1 104, 105 (trades of player contracts owned by professional football teams). Certain types of intangible personal property, such as securities, partnership interests, and 'choses in action', are specifically excluded under sections 1031(a)(2)(B) through (F). See, e.g., Rev. Rul. 78-135, 1978- 1 CB 256, considered in * * *, GCM 37347, I-340-77 (Dec. 15, 1977) (holding, prior to the 1984 legislative addition of partnership interests to the exclusions in 1031(a), that such interests are not eligible for section 1031 treatment); Reconsideration of Rev. Rul. 69- 467, GCM 38653, I-42-79 at 5-6 (Mar. 11, 1981) (reasoning that both a Federal oil and gas lease application and an overriding royalty interest contingent on issuance of the lease are 'choses in action' ineligible for section 1031 treatment). In our view, a slot does not represent an equity interest similar to stock or a partnership interest . Moreover, inasmuch as it entitles the slot-holder to present operating privileges, a slot is distinguishable from the type of contingent contractual interests found to be 'choses in action' in GCM 38653, supra.

Assuming, therefore, that the slot transferred and the slot received in an exchange are held by the taxpayer for the requisite productive business use or for investment, and not for sale within the meaning of section 1031(a)(2)(A), the exchange should be eligible for section 1031 nonrecognition treatment, if the 'like kind' requirement is satisfied.

As Treas. Reg. 1.1031(a)-1(b) indicates, the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under section 1031, be exchanged for property of a different kind or class.

Thus, in general, we would view two slots as properties of like kind, the exchange of which does not represent the taxable position of a taxpayer's property. Such differences as the fact that one slot is for take-off and the other exchanged slot is for landing, or that the two slots are for different times, would not afect the basic nature of the two slots to the extent that recognition treatment would be called for. Nor is there any reason to confine 'like-kind' treatment to intra-airport trades. A slot at one high density airport represents an investment similar to a slot at another high density airport, especially when one considers that a slot at one airport can never be considered in isolation, but is necessarily linked to a take-off or landing at another airport.

Prior to 1986, the FAA limited slot trades to one-for-one transactions. This restriction has been lifted under the buy/sell rule, raising an issue as to the tax treatment of a multiple slot trade, such as the exchange of a slot at one airport for two slots at another airport. While each case should be examined to determine whether the transaction is taxable, in whole or in part, nonrecognition treatment under section 1031 is not restricted to one-for-one exchanges, and a multiple slot trade could qualify. See Rev. Rul. 68-36, 1968-1 CB 357 (involving proper basis allocation in the case of a qualified section 1031 exchange of one rental property for two other rental properties); Rev. Rul. 73-476, 1973-2 CB 300 (exchange of interests in three separate real estate parcels for full ownership in one qualifies under section 1031).

Issue 5. REVERSION OF SLOT TO GOVERNMENT AS DEDUCTIBLE LOSS.

Under the buy/sell rule, a slot not used 65 percent of the time over a two-month period will revert to the FAA. In addition, slots may be withdraw by the FAA to fulfill operational needs. The possibility that a slot may revert in either of these situations raises issues as to the availability of a loss deduction under section 165 of the Code and, assuming a deduction is available, the amount and ordinary or capital character of the deduction.

a. ‘CLOSED AND COMPLETED TRANSACTION' REQUIREMENT.

Section 165(a) of the Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.

Treas. Reg. 1.165-1(b) provides that to be allowable as a deduction under section 165(a) of the Code, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Only a bona fide loss is allowable.

Treas. Reg. 1.165-2(a) provides that a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or when such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the tax year in which the loss is actually sustained.

In any case involving a claimed loss deduction, the facts of the case must be examined to determine, first, the relevant 'transaction', and second, whether that transaction was 'closed and completed'. See, e .g., Nicolazzi v. Commissioner, supra, 79 TC at 130-32 (portion of fees attributable to unsuccessful oil and gas lease applications not deductible, since 'transaction' was an integrated program designed to acquire one or more leases). A deduction is not allowable for a mere diminution in value of an asset. See, United States v. S.S. White Dental Manufacturing Co., 274 US 398 (1927); Louisiana Land & Exploration Co. v. Commissioner, 161 F2d 842 (5th Cir. 1947), aff'g, 7 TC 507 (1946), supra., 1946-2 CB 3 (with respect to an unrelated issue).

In most situations, the forfeiture of an airport slot under the 'use-or-lose' provision of the buy/sell rule would constitute an abandonment of a nondepreciable asset giving rise to a loss deduction as described in Treas. Reg. 1.165-2(a). To qualify as an abandonment, there must be intent to abandon and some overt act evidencing that intent. Dezendorf v. Commissioner, 312 F2d 95 (1963). These elements would normally be present in the case of deliberate non-use of a slot and forfeiture to the FAA under the use-or-lose provision. The involuntary withdrawal of a slot would also generally evidence a closed transaction. FAA records will show a definite point at which the slot reverted, fixing the timing of the loss. We would not

regard an individual slot as an inseverable portion of some larger asset (e.g., all the taxpayer's slots, other airport assets, etc.), such that its forfeiture would only mark a shrinkage in the value of some greater asset.

The 'closed transaction' requirement has been at issue in a number of situations in which certain government-created exclusive rights were later modified or terminated. The question has arisen, for example, when deregulation has decreased the value of a formerly exclusive privilege, or when one beneficial aspect of a license or other government-granted right, such as transferability, has been modified or restricted. See, e.g., Beatty v. Commissioner, 46 TC 835 (1966) (no loss when transferability of state liquor licenses was restricted); Rev . Rul. 84-145, 1984-2 CB 47 (no loss with respect totaxpayer-airline's CAB air route authority on deregulation of industry); Rev. Rul. 74-306, 1974-2 CB 58, considered in * * * , GCM 35727, I-5142 (March 15, 1974) (no loss on lifting of cotton acreage allotment penalties). COMPARE Trucking Deregulation--Effect on Operating Rights, GCM 38619, 1-337-80 (Jan. 21, 1981) WITH section 266 of the Economic Recovery Act of 1981, PL 97-34 (devaluation of ICC operating authorities). The two situations we are considering here, however, are distinguishable. The loss of a slot, whether through the operation of the 'use-or-lose' provision or FAA withdrawal, represents more than simply a diminution in value; the taxpayer has parted with all rights to use, sell, lease, or otherwise exploit the slot.

It should be noted that under section 165(b) of the Code and Treas. Reg. 1.165-1(c) the amount of loss allowable as a deduction is limited by the taxpayer as adjusted basis in the property. As discussed above, an incumbent slot-holder that received its slot from the government rather than by purchase will typically have no basis in that slot, and the reversion of a slot for such a taxpayer would therefore have no tax consequence.

b. CHARACTER OF LOSS.

Assuming that the reversion of a slot to the government gives rise to a deductible section 165 loss, and the taxpayer has basis in the slot, one final question is whether that loss will be ordinary or capital in nature.

Section 165(f) states that losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212. Section 1211 limits the deduction for capital losses. Section 1211(a), which applies only to corporations, allows a deduction for losses resulting from the sale or exchange of capital assets only to the extent of gains from the sale or exchange of capital assets. Section 1212 provides for capital loss carrybacks and carryforwards.

As discussed above under Issue 3, there are circumstances in which a slot will be an ordinary asset in a taxpayer's hands. Since section 165(f) only applies to capital assets, the general rule of section 165(a) would call for a deduction against ordinary income in the year of the loss in such cases.

Moreover, even if a slot qualified as a section 1221 capital asset, a loss stemming from reversion pursuant to the 'use-or-lose' or withdrawal provisions would normally be ordinary in nature because the 'sale or exchange' requirement in section 165(f) would not be met. The courts have interpreted the term 'exchange' as requiring that some benefit be received in return for what was lost. If, in fact, a slot- holder simply abandoned a slot or was required to forfeit a slot by the FAA, without receiving any benefit in return, there would be no 'sale or exchange'. It should be noted, however, that the courts have adopted a fairly broad concept of what constitutes an 'exchange' in this context. In Yarbro v. Commissioner, 737 F2d 479 (5th Cir. 1984), for example, the court held that the abandonment of real estate subject to a mortgage was a 'sale or exchange' giving rise to a capital rather than an ordinary loss because the taxpayer was relieved from the obligation, even though the mortgage was nonrecourse and the benefit did not proceed from the recipient of the property. See also Fancher v. United States, 62-2 USTC paragraph 9819 (WD SD 1962) (cancellation of taxpayer's liquor license actually a 'sale or exchange' because license was reissued to purchaser of taxpayer's liquor business pursuant to a prior understanding). Thus, forfeiture or withdrawal of a slot would result in an ordinary loss to the extent of basis-- whether or not it was a capital asset--unless, on the facts, there was some benefit to the slot-holder or other indication of a 'sale or exchange'.

James F. Malloy
Director
By:
Alan R. Fraser
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Interpretative Division

GENERAL COUNSEL MEMORANDUM 39536

Internal Revenue Service (I.R.S.)
General Counsel Memorandum (G.C.M.)
Date Numbered: July 17, 1986
March 11, 1986

Section 501 — Exemption From Tax on Corporations, Certain Trusts
Section 1031 — Exchange of Property Held for Productive Use or Investment

Charles M. Morgan III
Associate Chief Counsel (Technical)
Attention: Director, Corporation Tax Division

This responds to your memorandum of October 18, 1985, requesting our advice on the following issue.

ISSUE

Whether the taxpayer, a 'mutual ditch or irrigation company' under IRC 501(c)(12)(A), may make a section 1031 tax-free exchange of land in return for stock in another such company.

CONCLUSION

Because IRC 1031 specifically excludes stock from nonrecognition treatment, and because we do not think the state law characterization of mutual ditch company stock overrides this exclusion, the exchange would not qualify for the nonrecognition treatment of section 1031.

FACTS

Taxpayer is a 'mutual ditch or irrigation company' under section 501(c)(12)(A) of the Internal Revenue Code. It provides water to its member/shareholders, which include a * * * (* * *%) and farmer/rancher irrigators (* * *%). Taxpayer holds legal title to various parcels of land, water and water rights. Taxpayer proposes to convey a parcel of reservoir land (prime development land) valued at $ * * * to a developer, in exchange for $ * * * worth of stock in other 'mutual ditch or irrigation companies' and its own stock. Taxpayer presently owns stock in these companies and relies on their water to support some of its operations.

ANALYSIS

A. SECTION 1031 GENERALLY

IRC 1031 permits deferral of the recognition of gain realized in an exchange of property, and constitutes an exception to the general rule of IRC 1001(c) requiring recognition of gain upon the sale or exchange of property. Treas. Reg. 1.1002-1(b) provides that IRC 1031 must be construed strictly, and restricts nonrecognition under the section to exchanges that satisfy both the specific language and the underlying purpose of the section.
B. REQUIREMENTS FOR NONRECOGNITION UNDER SECTION 1031
Qualification for nonrecognition treatment under IRC 1031 requires an exchange of property held for productive use in a trade or business or for investment. The property transferred and the property received must be of 'like kind'. Certain property, however, is specifically excluded from qualification for nonrecognition treatment. These requirements will be examined separately in connection with the taxpayer's contentions.

1. 'LIKE-KIND PROPERTY' REQUIREMENT

Property received in an exchange must be of a 'like kind' to the property relinquished in the exchange. Treas. Reg. 1.1031(a)-l(b) provides:

As used in section 1031(a), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality . One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

Clearly real property is a different kind or class of property from stock for federal tax purposes. It cannot be said that stock in a mutual ditch of irrigation company differs only in grade or quality from a parcel of land. Because the proposed transaction presumes the exchange of real property for stock, the exchange, on its face, appears not to fulfill the 'like kind' requirement.

a. STATE LAW

The taxpayer, however, asserts that under Colorado law, ownership of shares of stock in a mutual ditch company is merely incidental to the ownership of water rights and therefore the taxpayer is receiving real property interests in the form of water rights in exchange for a parcel of land, thus qualifying as a 'like kind' exchange.

The taxpayer cites Jacobucci v. District Court, 189 Colo. 380, 541 P.2d 667, 672 (1975) for the proposition that shares of stock in a mutual ditch corporation represent a 'definite and specific water right, as well as a corresponding interest in the ditch, canal, reservoir, and other works by which the water right is utilized.' The issue in Jacobucci was whether the individual shareholders of a mutual ditch company were indispensable parties in an

action to condemn the shareholders' decreed water rights. The court stated that mutual ditch companies in Colorado exist solely for the convenience of their shareholders and represent the consumers' interest in the reservoir, canal, and water rights. Id. The court concluded that for STANDING PURPOSES (INDISPENSABLE PARTY ISSUE) because of the unique character of these corporations, a 'different treatment which is not fully in accord with the principles applicable to corporations in general' should be applied. Id.

The court in Jacobucci never suggested that the stock interest held by the shareholders was illusory. It merely stated that a shareholder in a mutual ditch corporation possessed one attribute of ownership representing a specific property interest in a water right, for indispensable party purposes. In fact, the court recognized that the rights of the shareholders were not identical to those of the corporation: 'The relationship between the corporation and its shareholders arises out of contract, implied in a subscription for stock and construed by the provisions of a charter and articles of incorporation'. Id. at 671. Additionally, 'the right of the corporation to hold title to the water rights and other property and to manage the affairs of the corporation, should be distinguished from the right of the shareholders to use the water on their lands.' Id. at 674. The court was not indicating that the rights of shareholders in a mutual ditch company are synonymous with corporate ownership rights in property held for productive use or investment.

The taxpayer also cites Great Western Sugar Co. v. Jackson Lake Reservoir and Irrigation Co., ___ Colo. ___, 681 P.2d 484 (1984) for the proposition that 'ownership of shares of stock in a mutual ditch corportion, unlike ownership of stock in other corporate entities, is merely incidental to the ownership of the water rights.' Id. at 491. Similar to Jacobucci, the court in Great Western Sugar Co. was deciding a narrow state law issue. The issue related to implied restrictions on the use of storage water derived as a result of ownership of stock in a mutual ditch company. The court in Great Western Sugar Co., as in Jacobucci, acknowledged that ownership of stock is not tantamount to possessing water rights. The court stated that shareholders' ownership rights are defined in part by the terms of the articles of incorporation, bylaws, corporate resolutions and terms of any applicable stock certificates. Id. at 490.

In Kendrick v. Twin Lakes Co., 58 Colo. 281, 144 P. 884 (1914) and Beaty v. Commissioners, 101 Colo. 346, 73 P.2d 982 (1937), the courts held that stock in mutual irrigation companies represented water rights which constituted part of the real estate and as such were taxable as part thereof. In Comstock v. Olney Springs Drainage Dist., 97 Colo. 416, 50 P.2d 531 (1935), the court similarly decided that because such stock represented the consumer's interest in the reservoir, canal, and water rights, an assessment based on a statute which enabled assessment on 'real property' was proper. The courts in the above cases, however, never intimated that mutual ditch company stock was sufficiently similar to real property so as to constitute 'like kind' property. The courts merely held that because this type of stock comprehended certain real property interests, it was subject to real property classification for specific local issues under certain circumstances. Because mutual ditch company stock encompasses other attributes, characteristics, and features, separate and distinct from those of real property, we believe that the exchange cannot satisfy the 'like kind' requirement.

Support for this position can be found in Denver Joint Stock Land Bank v. Markham, 106 Colo. 509, 107 P.2d 313, 315 (1940), where the Supreme Court of Colorado held that shares of stock in a mutual ditch company were not simply 'muniments of title' to water rights constituting real property. In Denver Joint Stock Land Bank, the issue was whether a deed that purported to transfer all 'water rights' did in fact transfer certain stock certificates in a mutual ditch company. The court distinguished Kendrick, Comstock and Beaty because of 'the dissimilarity of the facts involved', and held that because the shares of stock were not specifically mentioned in the deed, the shares were not transferred. Id. at 315-316.

Another related case is McComb v. Farmers Reservoir & Irrigation Co ., 167 F.2d 911 (10th Cir. 1948). In McComb, the issue was whether employees of an irrigation company were engaged in 'agriculture' within the exemption provisions of the Fair Labor Standards Act. If the employees were viewed as employees of the farmers, they would clearly fall within the exemption provisions. The court, citing Kendrick, Comstock and Beaty, stated that:

The defendant is a mutual irrigation company organized under the laws of Colorado, and it is the law of that state that IN RESPECT OF THE IMPOSITION OF SPECIAL ASSESSMENTS OR THE LEVYING OF AD VALOREM TAXES a corporation of that kind is to be treated as one organized for the convenience of its members in the distribution of water for use upon their land in proportion to their respective stock interests. . . . But local law, relating to the imposition of special assessments or the levying of ad valorem taxes is not the test for determining whether the employees of such a corporation are engaged in agriculture within the meaning of section 13(a)(b), supra.

The defendant is a corporate entity, separate and distinct from the farmers to whom it furnishes water for irrigation. Its employees are under its direction and control, and they are engaged in keeping its property in operating condition and in operating its irrigation system. They are not employed by the farmers and are not under their direction or control. . . . McComb at 915 (emphasis added).

Because of the corporate entity, employees were deemed to be engaged in activities 'separate and distinct from the farming operations of the farmers ' and therefore 'not engaged in agriculture' within the meaning of the Act. McComb at 915.

In some instances, an examination of relevant state law is in order to determine whether certain rights are to be considered property rights of a 'like kind'. See Commissioner v. Crichton, 122 F2d 181 (5th Cir. 1941), acq. 1952-1 CB 2, Rev. Rul. 55-749, 1955-2 CB 295, which was considered in ___, GCM 29118, A-615594 (Sept. 30, 1965). This, however, has only been applied to water, gas, oil and mineral rights. Because the characteristics of water, gas, oil and mineral rights are such that their property CLASSIFICATION is not readily apparent, state law has been considered in determining the nature of the legal interest possessed.

In GCM 29118 at 2, we concluded that 'under the circumstances in the instant case water facilities in an irrigation district are considered to be a necessary adjunct to arid land in such district so as to constitute property of like kind within the meaning of the statute.' This conclusion was based in part on a state statute which stated that both land and water rights were included within the definition of 'real property' or 'real estate' and that water rights were deemed appurtenant to and a part of the land irrigated thereby.

However, even assuming arguendo, that a state were to classify mutual ditch or irrigation stock as a real property interest, it would not necessarily follow that this classification would be accepted for federal tax purposes and the 'like kind' requirement. Because the classification of such stock is

readily apparent for 'like kind' purposes, state law classifications are not determinative. Although a water right could possibly be classified as real property for 'like kind' purposes under Colorado law, we believe that this 'classification' cannot be extended to mutual ditch company stock.

In Rev. Rul. 55-749, 1955-2 CB 295, the Service stated that the fact that two varieties of property, namely water rights and a fee interest in land, may be legally classified as real property, does not of itself signify that the two are property of like nature or character within the meaning of section 1031(a) of the Code. Citing Fleming v. Commissioner, 24 T.C. 818 (1955), the Service concluded that 'there must be considered not alone the nature and character of the physical properties but also the nature and character of the title conveyed or the rights of the parties therein' and that 'the properties exchanged must be of the same general character or of substantial equality'. Id. at 296.

We believe that in our situation as in McComb, the mutual ditch or irrigation company entity cannot be disregarded and that as in Denver Joint Stock Land Bank the mutual ditch company stock is not merely a 'muniment of title' to water rights. In other words, it is evident that the ownership of mutual ditch company stock comprehends significant rights, attributes and obligations which are distinct from those arising from the ownership of water rights. In the proposed transaction, therefore, stock, not water rights, would be exchanged for real property, thus resulting in an exchange that would not qualify as 'like kind'.

b. NATURE AND CHARACTER

Exemption depends upon the receipt of 'like kind' property. The Tax Court, in Koch v. Commissioner, 71 TC 54, 63-65 (1978), acq. 1979- CB 1 has aptly stated that,

The basic reason for allowing nonrecognition of gain or loss on the exchange of like kind property is that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the transaction occurred. '(I)f the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. H. Rept. 704, 73d Cong., 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 564. . . . The underlying assumption of section 1031(a) is that the new property is substantially a continuation of the old investment still unliquidated.' Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 268 (1958).

Thus, section 1031(a) requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature and character of the properties as distinguished from their grade or quality . . . . The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character.

We believe that the stock received is not 'substantially a continuation' of the parcel of land relinquished, 'still unliquidated.' The taxpayer immediately achieves a considerable degree of liquidity as a result of the exchange. Additionally, ownership attributes of the stock will be governed by Bylaws, Articles of Incorporation, voting rights, and other restrictions incident to the stock received. Therefore, the reason for allowing nonrecognition under the provisions of section 1031(a) would not apply.

2. EXCLUDED PROPERTY

a. GENERALLY

IRC 1031(a) specifically excludes certain categories of property from qualification for nonrecognition treatment. This is so regardless of the fact that the property exchanged would have been classified as 'like-kind', but for the express disqualification. IRC 1031(a)(2) specifically excludes stock or securities.

There apparently has been no controversy to date in determining when property constitutes 'stock' or when 'stock' might constitute real property for purposes of IRC 1031. There are neither regulations nor rulings on point. Nor is 'stock' defined in the Internal Revenue Code. We believe that the term 'stock' should be given its ordinary meaning, as evidence of the right of the holder or owner to share in the proceeds of a corporation's property, in the form of transferable shares of a specified amount. As previously stated, the corporate entity, together with its attributes, cannot be disregarded. Therefore, the certificates to be received by the taxpayer would constitute 'stock' and, as such, would not qualify for non-recognition treatment.

b. UNDERLYING PURPOSE

The 1921 Revenue Act 202(c)(1) did not exclude from nonrecognition, exchanges of stocks, bonds, notes, securities, etc. However, the specific exclusions emphasized above were added to the predecessor of IRC 1031 by the Act of March 4, 1923, which amended the Revenue Act of 1921. Pub. L. No. 545, 67th Cong., 4th Sess 42 Stat. 1560 (1923). The origins and articulated history of section 1031 disclose a concern for the taxpayer who continues to have his money tied up in similar property, and the basic unfairness of imposing a tax when there is a continuation of an unliquidated and relatively liquid investment. See H . Rept. No. 704, 73rd Cong., 2nd Sess. (1934), 1939-1 (Part 2) C.B. 564 . However, to the extent that the original provisions of the 1921 Act would be used in connection with the reinvestment of funds so as to avoid tax, an amendment was deemed necessary. See G. Holmes, 'Federal Taxes', 1923 edition, at 528. It was felt that this abuse was present especially in the case of stocks and bonds. See S. Rept. No. 1113, 67th Cong., 4th Sess. (1923), 1939-1 (Part 2) C.B. 845-846 (adopting H. Rept . No. 1432, 67th Cong., 4th Sess.)

The taxpayer does not continue to have his money tied up in similar property. Nor can it be said that there is a continuation of an unliquidated and relatively illiquid investment. It is essential to recognize that unless an exchange falls clearly within the provisions of this nonrecognition section, the question of taxability should be determined by the general principles enumerated in IRC 1001(c). Because exceptions to the general rules regarding

recognition of gains or losses must be strictly construed and because the transaction contemplates an exchange of stock for a parcel of land, the nonrecognition provisions of IRC 1031 would not apply.

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This document is not to be relied upon or otherwise cited as precedent by taxpayers.

PARKING ARRANGEMENTS

REVERSE EXCHANGES (ARTICLE)

REVERSE EXCHANGE BENEFITS

Revenue Procedure 2000-37 ("Rev. Proc. 2000-37"), provides guidelines for the taxpayer to acquire the replacement property before the sale of the relinquished property is completed. The reverse exchange can be the ideal solution if the taxpayer cannot delay the closing of the replacement property. The reverse exchange helps investors meet a number of objectives:

Seize the Moment: Don't miss out on the buy of a lifetime! Immediately acquire a desirable replacement property prior to selling the relinquished property.

Protect Your Exchange: Eliminate the pressure-filled problems presented by the 45-day identification period.

Improve the Replacement Property: Use the parking arrangement to increase the value of the replacement property by making capital improvements. Investors can take advantage of the current real estate market and still defer their capital gain by following Rev. Proc. 2000-37 safe harbor guidelines for a reverse exchange.

REVERSE EXCHANGE STRUCTURES

Rev. Proc. 2000-37 makes it clear that the Exchanger cannot own both properties at the same time. It describes the ownership process as a "parking arrangement" because either ownership of the relinquished property or the replacement property is "parked" with an Exchange Accommodation Titleholder ("EAT"). To "park" the ownership actually means that a deed is recorded to transfer the ownership to the EAT so that the Exchanger owns one property and the EAT owns the other property.

ADDITIONAL ISSUES

Parking the Replacement Property: The EAT acquires title to the replacement property with funds the Exchanger causes to be loaned to the EAT. Within 180 days, the Exchanger sells the relinquished property through the "delayed exchange" format and the EAT transfers the replacement property to the Exchanger.

Parking the Relinquished Property: The Exchanger conveys the relinquished property to the EAT and then the Exchanger acquires the replacement property under a "simultaneous exchange" format. During the 180 days, the EAT remains on title to the relinquished property until it is sold to a purchaser.

Reverse/Improvement Exchange: The EAT acquires the replacement property and makes improvements to this property. The improved property is later exchanged for the relinquished property within 180 days to complete the exchange.

REVERSE EXCHANGE COMPARISON (ARTICLE)

Often Exchangers may need to perform a reverse exchange in a "sellers market" where recently listed properties are quickly under contract with a buyer. The need for a §1031 reverse exchange arises when circumstances require that the replacement property be acquired before closing on the relinquished property. Revenue Procedure 2000-37 provides guidelines for the Exchanger to perform a "parking arrangement" exchange within 180 calendar days from the Exchange Accommodation Titleholder's (EAT) purchase of the replacement property.

"REPLACEMENT PROPERTY PARKED"

The EAT acquires title to the replacement property with funds the Exchanger causes to be loaned to the EAT. Within 180 days the Exchanger sells the relinquished property through the "delayed exchange" format and the EAT transfers the replacement property to the Exchanger.

Positives of the "Replacement Property Parked"

- Exchange equity need not be present.
- A deferred exchange may follow this format.
- Allows for multiple relinquished properties.

Negatives of the "Replacement Property Parked"

- Lender may have issues lending to the EAT.
- High costs - potential double transfer taxes and title insurance fees.

"RELINQUISHED PROPERTY PARKED"

The Exchanger conveys the relinquished property to the EAT and then the Exchanger acquires the replacement property under a "simultaneous exchange" format. During the 180 days, the EAT remains on title to the relinquished property until it is sold to a purchaser.

Positives of the "Relinquished Property Parked"

- Loan and purchase of replacement property easier since the loan is directly to the Exchanger.
- Possibly less expensive on transfer tax for relinquished property.
- Safer for EAT and Exchanger to hold title.

Negatives of the "Relinquished Property Parked"

- Equity and debt should match to avoid "boot"
- Transfer to EAT may increase county property tax basis.
- Lender issues on relinquished property (due on sale clause and prepayment penalties).

PARKING ARRANGEMENTS (ARTICLE)

KEY PORTIONS OF REV. PROC. 2004-51 ARE REFLECTED BELOW

Section 4.01 of Rev. Proc. 2000-37 provides that the Internal Revenue Service will not challenge the qualification of property held in a QEAA "as either 'replacement property' or 'relinquished property' (as defined in § 1.1031(k)-1(a)) for purposes of § 1031 and the regulations there under, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property...." Thus, taxpayers are not required to establish that the exchange accommodation titleholder bears the economic benefits and burdens of ownership and is the "owner" of the property. The Service and Treasury Department are aware that some taxpayers have interpreted this language to permit a taxpayer to treat as a like-kind exchange a transaction in which the taxpayer transfers property to an exchange accommodation titleholder and receives that same property as replacement property in a purported exchange for other property of the taxpayer.

An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of § 1031. *See DeCleene v. Commissioner*, 115 T.C. 457 (2000); *Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951). Rev. Rul. 67-255, 1967-2 C.B. 270, holds that a building constructed on land owned by a taxpayer is not of a like kind to involuntarily converted land of the same taxpayer. Rev. Proc. 2000-37 does not abrogate the statutory requirement of § 1031 that the transaction be an exchange of like-kind properties.*

The Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate. This revenue procedure applies to taxpayers applying the safe harbor rules set forth in Rev. Proc. 2000-37 in structuring like-kind exchanges.

Section 1 of Rev. Proc. 2000-37 is modified to read:

This revenue procedure provides a safe harbor under which the Internal Revenue Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

Section 4.01 of Rev. Proc. 2000-37 is modified to read:

The Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA. Property held in a QEAA may, therefore, qualify as either "replacement property" or "relinquished property" (as defined in § 1.1031(k)-1(a)) in a tax deferred like-kind exchange if the exchange otherwise meets the requirements for deferral of gain or loss under § 1031 and the regulations there under.

Section 4.05 is added to Rev. Proc. 2000-37 to read:

This revenue procedure does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder.

DONALD DECLEENE V. COMMISSIONER, 115 TC 457

Case Information: 115 T.C. No. 34

Code Sec(s):	1031
Docket:	Dkt. No. 24459-97.
Date Issued:	11/17/2000 .
Judge:	Opinion by Beghe, *J.*
Tax Year(s):	Year 1993.
Disposition:	Decision for Taxpayers in part and for Commissioner in part.

Counsel

Brian R. Mudd, for petitioners.

Michael J. Calabrese, for respondent.

BEGHE, *Judge*

Respondent determined for the taxable year 1993 that petitioners had a Federal income tax deficiency of $23,796 and were liable for a section 6662(a) [1] accuracy-related penalty of $4,759.

The sole substantive issue for decision is whether the subject transactions qualified as a taxable sale of the Lawrence Drive property and a like-kind section 1031(a)(1) exchange of the McDonald Street property, as petitioners reported them, or was a taxable sale of the McDonald Street property, as respondent determined. We uphold respondent's determination that the transactions resulted in a sale of the McDonald Street property, but we hold for petitioners on the penalty issue.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of fact and the accompanying exhibits are incorporated herein by this reference. Petitioners are husband and wife who resided in Green Bay, Wisconsin, at the time they filed their petition.

Since 1969, petitioner Donald DeCleene (petitioner) has owned and operated a trucking/truck repair business. In 1976 and 1977, petitioner purchased improved real property located on McDonald Street, Green Bay (the McDonald Street property). He used the McDonald Street property for his business operations.

In 1993, petitioners owned and worked as employees of DeCleene Truck Repair and Refrigeration, Inc. (Refrigeration). Petitioner served as president. Refrigeration installs and repairs truck refrigeration units and performs general truck repairs. Through December 29, 1993, Refrigeration rented the McDonald Street property from petitioner as its business [pg. 459]premises. Petitioner computed his adjusted basis for the McDonald Street property, including the depreciated cost of improvements, as being $59,831 at the time he disposed of that property on December 29, 1993.

In 1992, petitioner was looking for land to which he could move his business.

On September 30, 1992, petitioner purchased 8.47 acres of unimproved real property on Lawrence Drive in De Pere, Wisconsin (the Lawrence Drive property), a suburb of Green Bay. Petitioner described the Lawrence Drive property as a "very good spot" that he "took advantage of". Petitioner promptly sold 2.09 acres of the Lawrence Drive property to an unrelated corporation. Petitioner's adjusted basis of the Lawrence Drive property that he purchased and retained, with allocated fees and other closing costs, was $137,027.

Petitioner partially financed the purchase of the Lawrence Drive property with a $100,000 loan from Bank One, Green Bay. Bank One, Green Bay received petitioner's note and a mortgage on the Lawrence Drive property as security for its loan.

By 1993, petitioner was ready to move his business to a new building to be constructed on the Lawrence Drive property.

After petitioner acquired the Lawrence Drive property, The Western Lime and Cement Co. (WLC) expressed interest in acquiring petitioner's McDonald Street property.

Petitioner discussed WLC's interest in the McDonald Street property with his accountant. The accountant suggested that petitioner could structure a like-kind exchange in which he would quitclaim the Lawrence Drive property to WLC, after which WLC would convey back to petitioner the Lawrence Drive property with a new building built thereon to petitioner's specifications, in exchange for the McDonald Street property.

On September 24, 1993, WLC made an offer — prepared by petitioner's attorney — which petitioner accepted, to purchase the Lawrence Drive property for $142,400; petitioner's acceptance contained an undertaking to "transfer building permit to Buyer on or before September 27, 1993". [2] On [pg. 460]September 24, 1993, petitioner quitclaimed title to the Lawrence Drive property to WLC, and WLC gave petitioner a fully nonrecourse noninterest bearing one payment note and mortgage on the Lawrence Drive property in the amount of $142,400. On that same day, petitioner

assigned to Bank One, Green Bay, the WLC $142,400 note and mortgage. The WLC $142,400 note was due by its terms "upon the closing of an exchange transaction between" WLC and petitioner, or 6 months from the date of the note, "whichever is earlier".

On September 24, 1993, WLC and petitioner also executed the Exchange Agreement regarding the McDonald Street property and the Lawrence Drive property. The Exchange Agreement was drafted by petitioner's attorney with input from WLC's attorney.

Paragraph 1 of the Exchange Agreement required petitioner to convey by warranty deed the McDonald Street property to WLC, "free and clear of all liens and encumbrances", in exchange for WLC's paying its $142,400 note to petitioner and conveying the Lawrence Drive Property back to petitioner by quitclaim deed.

Paragraph 2 of the Exchange Agreement provided that petitioner would pay all costs relating to the transfers of the McDonald Street and Lawrence Drive properties.

In Paragraph 4 of the Exchange Agreement, petitioner made comprehensive warranties to WLC with respect to the McDonald Street property, but WLC expressly disavowed making any warranties to petitioner with respect to the Lawrence Drive property.

The Exchange Agreement provided that WLC would construct a building on the Lawrence Drive property to petitioner's specifications. [pg. 461]
The Exchange Agreement provided that petitioner at the closing of the exchange would pay an amount representing the costs of the building on the Lawrence Drive property, as well as insurance premiums, real estate taxes, interest, and all other "soft" costs WLC might incur incident to the construction of the building.

Petitioner in the Exchange Agreement agreed to indemnify and hold WLC harmless against any damages sustained or incurred in connection with the construction and financing of the Lawrence Drive property.

Petitioner and WLC intended to close on the Exchange Agreement upon completion of construction of the building on the Lawrence Drive property "but not later than December 31, 1993".

Bank One, Green Bay provided financing for the construction of the building on the Lawrence Drive property. On September 24, 1993, Bank One, Green Bay agreed to a construction loan of $380,000, naming WLC as borrower and petitioner as guarantor. This loan was nonrecourse as to WLC. On the same day WLC executed a note and mortgage to Bank One, Green Bay, which provided that WLC had no personal liability on the note secured by the mortgage and that the lender would look solely to the Lawrence Drive property securing the mortgage; petitioner guaranteed the $380,000 construction loan.

Bank One, Green Bay considered petitioner the source of repayment of the September 24, 1993, $380,000 construction loan. In connection with that loan, Bank One, Green Bay never obtained any financial statements from WLC. The check of the creditworthiness of WLC by the Bank One, Green Bay loan officer consisted of calling a branch bank to discuss WLC's business reputation.

The $380,000 note for the September 24, 1993 Bank One, Green Bay construction loan required no interest or principal payments during the time that WLC was expected to be the named borrower on the note; the note did not require payment of interest until March 23, 1994.

On September 24, 1993, the following other events occurred: Petitioner gave Bank One, Green Bay a new mortgage on the McDonald Street property securing a total obligation of $480,000, consisting of both his September 30, 1992, $100,000 note and the WLC nonrecourse note of [pg. 462] $380,000 that he had guaranteed; WLC accepted the commitment of Bank One, Green Bay to provide a $380,000 loan for financing construction of the building on the Lawrence Drive property; WLC executed a corporate borrowing resolution authorizing it to borrow from Bank One, Green Bay; WLC executed an application to Bank One, Green Bay for a standby letter of credit in the amount of $380,000 in favor of the title company, which was delegated the task of making progress payments to the contractor under the construction contract; the bank issued its irrevocable standby credit in favor of the title company in that amount.

On September 24, 1993, Landmark Building Systems Ltd. (Landmark) entered into a lump sum construction contract in the amount of $375,688 (subject to certain adjustments) with WLC to construct the building on the Lawrence Drive property. The contract named petitioner, Mike DeCleene (petitioners' son, who works in the family business), and/or a representative of Excel Engineering, as owner's representative. As owner's representative, petitioner and Mike DeCleene had general authority, including the right to approve changes in design or construction, to inspect and approve workmanship and materials, to visit the construction site, and to determine compliance with the contract.

Although the standby letter of credit and the construction contract do not expressly so state, progress payments to the contractor were to be made only with the approval of petitioner or Michael DeCleene as owner's representative. Excel Engineering played a role in the design of the building, but lacked actual authority to sign off as owner's representative.

The construction contract called for substantial completion by December 15, 1993. Between September 24 and December 29, 1993, Landmark worked on the construction of the building on the Lawrence Drive property and substantially completed the building to petitioner's specifications.

On December 28, 1993, 1 day prior to execution and closing of the Assumption, Release and Escrow Agreement described below, Bank One, Green Bay executed a Satisfaction of Mortgage for the mortgage given by WLC to petitioner that petitioner had assigned to the bank in connection with petitioner's quitclaim of the Lawrence Drive property to WLC on September 24, 1993. [pg. 463]

On December 29, 1993, Bank One, Green Bay, WLC, and petitioner executed the Assumption, Release and Escrow Agreement, which provided that petitioner assumed and became personally obligated to the bank for all obligations of WLC arising out of the construction note and mortgage,

notwithstanding their nonrecourse language; petitioner agreed to be responsible for completion of the construction project; and WLC agreed to pay petitioner $142,400 for the McDonald Street property. Petitioner undertook to use $100,000 of the $142,400 received from WLC "to pay a Note due the Bank in the amount of *** $100,000" (which had been secured by mortgages on both the Lawrence Drive property and the McDonald Street property) and to escrow the remainder with the bank to pay real estate taxes and any special assessments on the McDonald Street property and to reduce the balance of the construction loan note and mortgage to $360,000, with any surplus of the escrowed funds to be delivered to petitioner. Bank One, Green Bay agreed "to release any liens that it may have on the property located on McDonald Street".

On December 29, 1993, petitioner formally assumed as borrower what had been WLC's nonrecourse $380,000 Bank One, Green Bay note of September 24, 1993; petitioner conveyed the McDonald Street property to WLC by warranty deed. WLC quitclaimed to petitioner its interest in the Lawrence Drive property. WLC directly paid petitioner $142,400 by check to petitioner's order drawn on M&I First National Bank of West Bend, Wisconsin. Petitioner endorsed this check "Pay only to the order of Bank One-Green Bay".

Petitioner and WLC had agreed in the Exchange Agreement that the McDonald Street property, including improvements, and the unimproved Lawrence Drive property each had a value of $142,400. The quitclaim deed of the Lawrence Drive property from petitioner to WLC and the warranty deed of the McDonald Street property from petitioner to WLC each showed that real estate transfer tax of $427.20 had been paid, based on a value of $142,400; the quitclaim deed from WLC to petitioner of the title to the improved Lawrence Drive [pg. 464]property showed that real estate transfer tax of $1,140 had been paid, based on a value of $380,000. [3]

Although petitioner had a general desire to complete his acquisition of the improved Lawrence Drive property as soon as possible, he didn't particularly care whether the closing occurred before or after December 31, 1993. WLC wished to have the closing occur before December 31, 1993, because it wanted the Lawrence Drive property removed from its books for insurance valuation purposes before the end of the year.

On their 1993 return, petitioners treated the subject transactions between petitioner and WLC as a sale of the unimproved Lawrence Drive property and a like-kind exchange of the McDonald Street property for the improved Lawrence Drive property. Petitioners reported no gain or loss on the disposition of the McDonald Street property. They reported a $5,373 short-term capital gain ($142,400 gross "sales price" less $137,027 basis) on their quitclaim transfer of the Lawrence Drive property to WLC, which is described in Schedule D of their return as a sale of "investment land".

Petitioners' 1993 return includes a Form 8824, Like-Kind Exchanges, which states that petitioners exchanged "land and building" for "land and building". The return discloses no other facts regarding the transactions between petitioner and WLC.

Respondent used petitioner's $59,831 adjusted basis figure for the McDonald Street property in computing the long-term capital gain on the sale of the McDonald Street property determined in the deficiency notice. However, on audit of petitioners' return, an adjusted basis of $61,331 had been established. Respondent's deficiency notice did not back out the gain petitioners had reported on petitioner's quitclaim transfer of the unimproved Lawrence Drive property to WLC, notwithstanding that, under respondent's theory of the case, the Lawrence Drive property has never been disposed of by petitioner.

On April 29, 1998, Bank One, Green Bay, WLC, and petitioner executed an amendment to the Assumption, Release and Escrow Agreement. The amendment recites that the original of that agreement contained a scrivener's error, and [pg. 465]recites that WLC would pay petitioner $142,400 "*in satisfaction of the Note and Mortgage" on the Lawrence Drive property, that the Lawrence Drive Property "is exchanged per the Exchange Agreement" for the McDonald Street property*, that petitioner will use $100,000 of the $142,400 received from WLC to pay petitioner's $100,000 note to the bank, and that the balance of $42,400 will be escrowed with the bank to pay real estate taxes and any special assessments on the *Lawrence Drive property* (emphases supplied) and to reduce the balance of the construction loan and mortgage to $360,000.

The amendment also sets forth a revision of the provision regarding release of liens by Bank One, Green Bay, reading as follows:

The Bank agrees to release any liens that it may have on the property located at 625 Lawrence Drive, De Pere, Wisconsin, that are the obligation of the Company [WLC] and against 917 MacDonald [sic] Street, Green Bay, Wisconsin that are the obligation of DeCleene.

The terms of the foregoing transactions among WLC and petitioner and Bank One, Green Bay assured that WLC would pay no amounts thereunder until it received the McDonald Street property, that WLC would have no personal liability with respect to the Lawrence Drive property or financing while the Lawrence Drive property was titled in its name or at any time thereafter, and that all transaction and other costs with respect to the McDonald Street and Lawrence Drive properties would be paid by petitioner.

OPINION

Section 1001(c) provides that the entire gain or loss on the sale or exchange of property shall be recognized. Section 1031(a)(1) provides for nonrecognition of gain or loss on the exchange of certain types of like-kind property, including real property, held for productive use in trade or business or for investment. [4] Section 1031(b) in effect provides that if the [pg. 466]property received in an exchange otherwise qualifying for nonrecognition of gain under section 1031(a) includes money or other property ("boot"), then any gain to the recipient shall be recognized, but not in excess of the boot.

Was McDonald Street Sold or Exchanged?

The question posed by respondent's determination is whether the subject transactions were a taxable sale to WLC of the McDonald Street property, as respondent determined, or instead were a taxable sale of the unimproved Lawrence Drive property to WLC, followed 3 months later by petitioner's transfer of the McDonald Street property to WLC in a like-kind exchange for WLC's reconveyance to petitioner of the Lawrence Drive property — now substantially improved — as petitioners reported.

The tax significance of the answer to the question stems from the disparity in the adjusted bases of the McDonald Street and Lawrence Drive properties in petitioner's hands. McDonald Street, which petitioner purchased in 1976-77, had an adjusted basis in his hands substantially lower than his cost of Lawrence Drive, which he purchased in 1992. Petitioner therefore reported as the taxable sale not his permanent relinquishment to WLC of the low- basis McDonald Street property, but rather the first leg of the "repo" transaction that temporarily parked the high-basis Lawrence Drive property with WLC.

Legal and Administrative Background

The primary reason that has been given for deferring recognition of gain under section 1031(a) on exchanges of like-kind property is that the exchange does not materially alter the taxpayer's economic position; the property received in the exchange is considered a continuation of the old property still unliquidated. See, e.g., Koch v. Commissioner, 71 T.C. 54, 63-64 (1978). However, section 1031(a) does not go so far in implementing this notion as to be a reinvestment rollover provision, like section 1033 or section 1034. A sale of qualified property for cash requires that gain or loss be recognized under the general rule of section 1001(c); such a sale does not become part of a qualifying exchange under section 1031(a) [pg. 467]even though the cash received on the sale is immediately invested in like property. Compare Coastal Terminals, Inc. v. United States, 320 F.2d 333, 337 [12 AFTR 2d 5247] (4th Cir. 1963), with Rogers v. Commissioner, 44 T.C. 126, 136 (1965), affd. per curiam 377 F.2d 534 [19 AFTR 2d 1508] (9th Cir. 1967).

Petitioners remind us, and we are well aware — as we stated in another section 1031 exchange case in which we held against the taxpayer — that "Notwithstanding the familiar and long-standing rule that exemptions are to be narrowly or strictly construed, *** section 1031 has been given a liberal interpretation." Estate of Bowers v. Commissioner, 94 T.C. 582, 590 (1990) (citing Biggs v. Commissioner, 69 T.C. 905, 913-914 (1978), affd. 632 F.2d 1171 [47 AFTR 2d 81-484] (5th Cir. 1980)). The courts have exhibited a lenient attitude toward taxpayers in like-kind exchange cases, particularly toward deferred exchanges. See, e.g., Starker v. United States, 602 F.2d 1341 [44 AFTR 2d 79- 5525] (9th Cir. 1979). The Commissioner has also played a facilitating role by issuing regulations that provide safe harbors for deferred exchanges, see sec. 1.1031(k)-1, Income Tax Regs., under the statutory limitations imposed on such exchanges by section 1031(a)(3), as enacted by Deficit Reduction Act of 1984, Pub. L. 98-369, sec. 77(b), 98 Stat. 596. These regulations, with their provisions for use of third-party "qualified intermediaries" as accommodation titleholders, who will not be considered the taxpayer's agent in doing the multiparty deferred exchanges permitted by the regulations, have encouraged the growth of a new industry of third-party exchange facilitators.

The subject transactions present a case of first impression in this Court. They reflect the effort of petitioner and his advisers to implement a so-called reverse exchange directly with WLC, without the participation of a third-party exchange facilitator. Reverse exchanges have been described as transactions in which the taxpayer locates and identifies the replacement property (and acquires it or causes it to be acquired on his behalf by an exchange facilitator) before he is ready to transfer the property to be relinquished in exchange. The preamble to the deferred exchange regulations, sec. 1.1031(k)-1, Income Tax Regs., made clear the Commissioner's view that section 1031(a)(3) and the deferred-exchange regulations do not apply to reverse exchanges. See T.D. 8346, 1991-1 C.B. 150, 151. [pg. 468]

The Commissioner has recently responded to industry and practitioner requests for guidance [5] by publishing a revenue procedure describing the Commissioner's conditions for qualifying reverse exchanges for nonrecognition of gain under section 1031(a)(1). See Rev. Proc. 2000-37, 2000-40 I.R.B. 308. Like the deferred exchange regulations that implement section 1031(a)(3), the revenue procedure provides for third-party qualified intermediaries as exchange accommodation titleholders in carrying out the "qualified exchange accommodation arrangements" whose use will qualify reverse exchanges for nonrecognition of gain or loss under section 1031(a)(1). Like the deferred exchange regulations, the revenue procedure provides a safe harbor; it states that "the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided this revenue procedure", but that "no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor". Rev. Proc. 2000-37, 2000-40 I.R.B. 308.

Because the revenue procedure is prospectively effective, it does not apply to the case at hand. See id. We therefore have recourse to general principles of tax law to answer the question posed by respondent's determination.

Analysis and Conclusion

In the case at hand, petitioner did not just locate and identify the Lawrence Drive property in anticipation of acquiring it as replacement property in exchange for the McDonald Street property that he intended to relinquish. He purchased the Lawrence Drive property without the participation of an exchange facilitator a year or more before he was ready to relinquish the McDonald Street property and relocate his business to the Lawrence Drive property. In the following year, petitioner transferred title to the Lawrence Drive property, subject to a reacquisition agreement — the Exchange Agreement — not to a third- party exchange facilitator, but to [pg. 469]WLC, the party to which he simultaneously obligated himself to relinquish the McDonald Street property.

In forgoing the use of a third party and doing all the transfers with WLC, petitioner and his advisers created an inherently ambiguous situation. The ambiguity is exacerbated by the fact that petitioner and WLC agreed in the Exchange Agreement that the McDonald Street property and the unimproved Lawrence Drive property were of equal value, $142,400. So when WLC paid petitioner $142,400 — at the same time that he permanently relinquished the McDonald Street property to WLC — was the payment received by petitioner from WLC the sale price of the McDonald Street property at the December 29 closing, as respondent determined? Or was it the deferred purchase price on petitioner's September 24 quitclaim transfer of title to the unimproved Lawrence Drive property (which petitioner received back on December 29 from WLC with the substantially completed building that had been erected on it in the intervening 3 months), as petitioner reported?

Our approach to answering these questions is to determine for tax purposes whether WLC became the owner of the Lawrence Drive property during the 3- month period it held title to the property while the building was being built on it to petitioner's specifications. If petitioner remained the owner of the Lawrence Drive property during this period, petitioner could not engage in a qualified like-kind exchange of the McDonald Street property for

the Lawrence Drive property, and the $142,400 payment received by petitioner would be deemed the sale price of the McDonald Street property. A taxpayer cannot engage in an exchange with himself; an exchange ordinarily requires a "reciprocal transfer of property, as distinguished from a transfer of property for a money consideration". Sec. 1.1002-1(d), Income Tax Regs.

WLC did not acquire any of the benefits and burdens of ownership of the Lawrence Drive property during the 3-month period it held title to that property. WLC acquired no equity interest in the Lawrence Drive property. WLC made no economic outlay to acquire the property. WLC was not at risk to any extent with respect to the Lawrence Drive property because the obligation and security interest it gave back on its purported acquisition of the property were nonrecourse. WLC merely obligated itself to reconvey to petitioner prior to [pg. 470] yearend the Lawrence Drive property with a substantially completed building on it that had been built to his specifications and that pursuant to prearrangement he was obligated to take and pay for.

The parties treated WLC's holding of title to the Lawrence Drive property as having no economic significance. The transaction was not even used as a financing device. No interest accrued or was paid on the nonrecourse note and mortgage, which assured that petitioner would get back the Lawrence Drive property after it had been improved. WLC had no exposure to real estate taxes that accrued with respect to the property while WLC held the title; all such taxes were to be paid by petitioner. No account was to be taken under the terms of the reacquisition agreement of any value that had been added to the property by reason of the building constructed in the interim. The construction was financed by petitioner through the bank he was accustomed to dealing with. Petitioner through his guaranty and reacquisition obligation was at all times at risk with respect to the Lawrence Drive property. WLC had no risk or exposure with respect to the additional outlay of funds required to finance construction of the building. WLC had no potential for or exposure to any economic gain or loss on its acquisition and disposition of title to the Lawrence Drive property.

The reality of the subject transactions as we see them is a taxable sale of the McDonald Street property to WLC. Petitioner's purchase in 1992 of the Lawrence Drive property, on which he intended to build a new facility for his business as the replacement for his McDonald Street property, put him in the position of arranging to improve the Lawrence Drive property, as well as to sell the McDonald Street property. Petitioner's prior quitclaim transfer to WLC of title to the unimproved Lawrence Drive property, which petitioners try to persuade us was petitioner's taxable sale, amounted to nothing more than a parking transaction by petitioner with WLC, which contractually bound itself to acquire from petitioner the McDonald Street property that petitioner was going to relinquish permanently, as well as to reconvey to petitioner the Lawrence Drive property as soon as the facility to be built thereon to his specifications was substantially completed. [pg. 471]

The reconveyance to petitioner of the Lawrence Drive property was not part of an exchange by petitioner of the McDonald Street property. That reconveyance of the Lawrence Drive property to petitioner merely reunited in his hands the bare legal title to the Lawrence Drive property with the beneficial ownership therein that he had continued to hold all along while the building that he obligated himself to pay for was being built to his specifications.

In support of their claim that petitioner exchanged the McDonald Street property for the improved Lawrence Drive property, petitioners point out that the improved Lawrence Drive property was different from the unimproved Lawrence Drive property that he acquired in 1992 and whose title he transferred to WLC on September 24, 1993. Petitioners state: "Petitioners sold unimproved land (and reported the transaction) and in the exchange got back improved real estate they could continue their business operation in." It's true that unimproved property and improved property are different from each other; they are not "similar or related in service or use" for the purpose of the section 1033 rollover provision. See sec. 1.1033(a)-2(c)(9), Income Tax Regs. However, the transformation of the Lawrence Drive property while title was parked with WLC does not gainsay our conclusion. In substance, petitioner never disposed of the Lawrence Drive property and remained its owner during the 3-month construction period because the transfer of title to WLC never divested petitioner of beneficial ownership.

Having set forth our analysis and conclusion, we now address the authorities cited by petitioners [6] as favoring their position or as being distinguishable. [pg. 472]

Authority in the Court of Appeals for the Seventh Circuit

The only case in the Seventh Circuit — the circuit to which any appeal would lie in the case at hand — that the parties have brought to our attention is Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 [40 AFTR 648] (7th Cir. 1951), affg. a Memorandum Opinion of this Court dated Aug. 10, 1950. [1950 PH TC Memo ¶50,190] Petitioners try to distinguish the Bloomington Coca-Cola Bottling Co. case, but we find it highly instructive.

The taxpayer had originally reported the transaction in issue as a sale at a loss in the year it occurred, 1939, but contended — for 1943 and 1944 excess profits tax purposes — that the transaction had been an exchange under the statutory predecessor of section 1031(a) in which no loss had been recognized. The taxpayer's change in position was attributable to its desire not to reduce its excess profits tax base.

The taxpayer had outgrown its old bottling plant and hired a contractor to erect a new plant, on the taxpayer's land, at an agreed cost of $72,500. Included in the consideration paid by the taxpayer to the contractor was the old bottling plant and the parcel of land on which it was located, at an agreed value of $8,000, plus cash of $64,500. The taxpayer reported on its 1939 income tax return a loss of approximately $23,000 on the sale of the old plant.

As this Court pointed out in its Memorandum Opinion: "Here the contractor was not the owner of the land upon which the new building was constructed, never owned the new building, and never conveyed the new building to the petitioner".

The Tax Court held — and the Court of Appeals affirmed — that the transaction was in effect the purchase of a new facility, and not an exchange of unimproved property for improved property, inasmuch as the taxpayer already owned the land on which the new plant was constructed. The contractor could not be a party to an exchange with the taxpayer because the contractor was never the owner of the property that the taxpayer

received in the so-called exchange. The contractor was merely acting as a service provider in the construction of the new plant. The only real property to which the contractor acquired title was the land and old plant that it received as part payment for the construction services it provided. [pg. 473]

The subject transactions are similar to those in Bloomington Coca-Cola Bottling Co. v. Commissioner, supra, in significant respects. The taxpayer sold its old bottling plant (petitioner sold the McDonald Street property) to the only other party it was dealing with, the contractor (WLC). The taxpayer hired a contractor to build a new facility on land that it owned. In the case at hand, petitioner's conveyance of title to the unimproved Lawrence Drive property and the conveyance of that property back with a substantially completed building on it are to be disregarded; WLC never acquired any of the benefits and burdens of ownership of the Lawrence Drive property. WLC acquired no equity or beneficial interest in the Lawrence Drive property, no risk of loss or opportunity for gain, no exposure to real estate taxes or other carrying charges, no liability even for interest on its nonrecourse secured obligation during the interim period. All we are left with, as in Bloomington Coca-Cola Bottling Co., is that a building was built for petitioner according to his specifications on land that he owned and petitioner was obligated to pay for that building. The taxpayer in Bloomington Coca-Cola Bottling Co. and petitioner also sold their old property to the party with whom they dealt in connection with the building of the new facility. [7]

Authorities Relied on by Petitioners

We now turn to the cases petitioners rely on to support their contention that petitioner exchanged the McDonald Street property for the substantially improved Lawrence Drive property: J.H. Baird Publg. Co. v. Commissioner, 39 T.C. 608 (1962); Coupe v. Commissioner, 52 T.C. 394, 409-410 (1969); 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975); Biggs v. Commissioner, 69 T.C. 905 (1978), affd. 632 [pg. 474]F.2d 1171 [47 AFTR 2d 81-484] (5th Cir. 1980); Fredericks v. Commissioner, T.C. Memo. 1994-27 [1994 RIA TC Memo ¶94,027].

We preface our review of these cases by acknowledging that they all reflect, to some degree, the liberal interpretation in favor of taxpayers that this Court and other courts have applied in cases under section 1031(a)(1). We also observe that none of these cases concerned a reverse exchange and that all of them are highly fact specific and therefore distinguishable from the case at hand. Petitioners have read these cases selectively, emphasizing in each of them what the taxpayer got away with. In so doing, petitioners have lost sight of the cumulative adverse effect on their position of all the facts in the case at hand, which have led to our conclusion that WLC never acquired beneficial ownership of the Lawrence Drive property. It would therefore be a sterile exercise to engage in a detailed recitation of the facts of these cases and a point-by-point refutation of their applicability to the case at hand. A couple of highlights from J.H. Baird Publg. Co. v. Commissioner, supra, will suffice.

Petitioners try to make something of the fact that the Court in J.H. Baird Publg. Co. v. Commissioner, 39 T.C. at 618, distinguished Bloomington Coca-Coca Bottling Co. v. Commissioner, 189 F.2d 14 [40 AFTR 648] (7th Cir. 1951), on the ground that "It was clear that the contractor did not own the other property which, it was claimed, was transferred to the taxpayer in the exchange." As already indicated, we have found dispositive in the case at hand that WLC never acquired beneficial ownership of the Lawrence Drive property. [8] WLC merely served as an accommodation party, providing the parking place for legal title to the Lawrence Drive property, while petitioner remained the beneficial owner before and after and throughout the 3- month focal period of the subject transactions.

When petitioner conveyed to WLC title to the Lawrence Drive property, WLC became contractually bound to reconvey it, and petitioner was bound to take it back, prior to yearend (not much more than 3 months). Indeed, under Wisconsin law, both parties were entitled to specific performance of the [pg. 475]other party's obligation. See Anderson v. Onsager, 455 N.W.2d 885 (Wis. 1990); Heins v. Thompson & Flieth L. Co., 163 N.W. 173 (Wis. 1917). It's difficult to imagine commitments more binding than the reciprocal obligations of petitioner and WLC in the case at hand. The conveyance and reconveyance of title to the Lawrence Drive property must be disregarded as having no tax significance because, at the end of the day, petitioner ended up where he started, with title to and beneficial ownership of the Lawrence Drive property. [9]

Computational Questions

Petitioners point out that respondent's deficiency notice, which made an upward adjustment of $82,569 in long-term gain realized and recognized by petitioners on the disposition of the McDonald Street property, which we have found to be the actual sale, failed to back out the short- term gain of $5,373 that petitioners reported on the transfer of title to the unimproved Lawrence Drive property. Petitioners' point is well taken. It should be addressed in the Rule 155 computation.

Similarly, other matters not completely resolved, such as the calculation of additional costs paid by petitioner in connection with the sale of the McDonald Street property, as well as his adjusted basis in that property, should be addressed in the Rule 155 computation of the gain on the sale.

Penalty Question

The subject transactions were structured by petitioner's accountant and attorneys after petitioner presented them with the accomplished fact of his purchase of the Lawrence Drive property. Petitioners' 1993 income tax return, prepared by petitioner's accountant, reported a taxable short-term gain of $5,373 on the sale of "investment land" and reported a like-kind exchange of "land and building" for "land and building" on Form 8824. The disclosures were bare bones but adequate to trigger the audit that led to the deficiency notice and the case at hand. [pg. 476]

Respondent determined that petitioners were liable for an accuracy-related penalty under section 6662(a) and (b)(1) or (2). Section 6662(a) imposes a 20-percent accuracy-related penalty on the portion of an underpayment that is due to one or more causes enumerated in section 6662(b). Respondent relies on subsections (b)(1) (negligence or intentional disregard of rules or regulations) or (b)(2) (substantial understatement of income tax).

Petitioners argue they are not liable for the penalty. Petitioners point out that a certified public accountant outlined the subject transactions as they were carried out and prepared their return and that the deal was structured and the papers drawn by petitioners' attorneys. Petitioners contend that

they reasonably relied on professional advice in the preparation of their return and that they are entitled to relief under the exceptions that apply to a substantial understatement.
Negligence includes a failure to attempt reasonably to comply with the Code. See sec. 6662(c). Disregard includes a careless, reckless, or intentional disregard. See id. Negligence is the failure to exercise due care or the failure to act as a reasonable and prudent person. See Neely v. Commissioner, 85 T.C. 934, 947 (1985).

No penalty is imposed for negligence or intentional disregard of rules or regulations or a substantial understatement of income if the taxpayer shows that the underpayment is due to reasonable cause and the taxpayer's good faith. See sec. 6664(c); secs. 1.6662-3(a), 1.6664-4(a), Income tax Regs.

Reasonable cause requires that the taxpayer have exercised ordinary business care and prudence as to the disputed item. See United States v. Boyle, 469 U.S. 241 [55 AFTR 2d 85-1535] (1985); see also Estate of Young v. Commissioner, 110 T.C. 297, 317 (1998). The good faith, reasonable reliance on the advice of an independent, competent professional as to the tax treatment of an item may meet this requirement. See United States v. Boyle, supra; sec. 1.6664-4(b), Income Tax Regs.; see also Richardson v. Commissioner, 125 F.3d 551 [80 AFTR 2d 97-6395] (7th Cir. 1997), affg. T.C. Memo. 1995-554 [1995 RIA TC Memo ¶95,554]; Ewing v. Commissioner, 91 T.C. 396, 423 (1988), affd. without published opinion 940 F.2d 1534 (9th Cir. 1991). [pg. 477]

Whether a taxpayer relies on advice and whether such reliance is reasonable depend on the facts and circumstances of the case and the law that applies to those facts and circumstances. See sec. 1.6664-4(c)(i), Income Tax Regs. A professional may render advice that may be relied upon reasonably when he or she arrives at that advice independently, taking into account, among other things, the taxpayer's purposes for entering into the underlying transaction. See sec. 1.6664-4(c)(i), Income Tax Regs.; see also Leonhart v. Commissioner, 414 F.2d 749 [24 AFTR 2d 69-5452] (4th Cir. 1969), affg. T.C. Memo. 1968-98 [¶68,098 PH Memo TC]. Reliance is unreasonable when the taxpayer knew, or should have known, that the adviser lacked the requisite expertise to opine on the tax treatment of the disputed item. See sec. 1.6664-4(c), Income Tax Regs.

In sum, for a taxpayer to rely reasonably upon advice so as possibly to negate a section 6662(a) accuracy-related penalty determined by the Commissioner, the taxpayer must prove that the taxpayer meets each requirement of the following three-prong test: (1) The adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. See Ellwest Stereo Theatres, Inc. v. Commissioner, T.C. Memo. 1995-610 [1995 RIA TC Memo ¶95,610]; see also Rule 142(a).

We conclude on the record before us that petitioners actually relied in good faith on disinterested professional advisers who structured the transactions and prepared their return. Petitioners were justified in their reliance, notwithstanding that we have upheld respondent's determination that the subject transactions did not qualify as a like-kind exchange of the Lawrence Drive property. Accordingly, we hold for petitioners on the penalty issue.

To give effect to the foregoing,

Decision will be entered under Rule 155.

[1]

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2]

The copy of the building permit included as Exhibit 39-J in paragraph 67 of the Supplemental Stipulation of Facts replaces paragraph 30 of the Stipulation of Facts, which stated as follows: "Prior to his September 24, 1993 quit claim of title to the Lawrence Drive property to the Western Lime & Cement Co., a permit was obtained in Donald DeCleene's name for construction of a building on the Lawrence Drive property".
Exhibit 39-J is a photocopy that bears a variety of dates: it was originally submitted to and preliminarily approved by the City of DePere Building Inspector on July 29, 1993; it bears the signature of the "Owner/Agent Michael DeCleene V.P. Date 1/12/94"; it was recorded "10/22/93" and bears the notation, "Site Plan approved by Plan Commission on 4-27-93". The name of petitioner as Owner, his mailing address, and telephone number appear on the line of the permit form provided for that information. However, the name, mailing address, and telephone number of WLC have been written in above those of petitioner.
On July 29, 1993, Green Bay Abstract & Title Company, Inc. (the title company), had issued a title commitment with WLC as the proposed insured on the owner's policy in the insured amount of $142,400 and Bank One, Green Bay as the proposed insured on the loan policy in the insured amount of $522,400.

[3]

Although these amounts do not computationally coincide in all respects with the transfer tax figures shown on the buyer's and seller's closing statements, those statements confirm that the transfer taxes on the subject transactions were paid by petitioner.

[4]

Clearly, the Lawrence Drive property, in both its unimproved and improved states, and the McDonald street property were like-kind properties within the meaning of sec. 1031(a). Sec. 1.1031(a)-1(b), Income Tax Regs., states:

Definition of "like kind." As used in section 1031(a), the words "like kind" have reference to the nature or character of property and not to its grade or quality. *** The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. ***

5

See, e.g., American Bar Association Section on Taxation, Committee on Sales, Exchanges and Basis, Report on the Application of Section 1031 to Reverse Exchanges, 21 J. Real Est. Tax. 44 (1993); Handler, Pricewaterhouse Coopers Forwards Proposed Guidance on Reverse Exchanges, 2000 TNT 16-27, Doc. 2000-2588 (Jan. 25, 2000); Safe Harbor Guidance for Reverse Like-kind Exchanges To Come Soon, IRS Official Promises, Highlights and Documents 1157 (Jan. 25, 2000).

6

Petitioners contend that their advisers relied on two private letter rulings in structuring the subject transactions: Priv. Ltr. Rul. 78-23- 035 (Mar. 9, 1978), which they characterize as "nearly identical to the facts in our case", and Priv. Ltr. Rul. 91-49-018 (Sept. 4, 1991), which they cite as "virtually directly on point (even goes farther than our case) on how a transaction can be structured". Petitioners' contentions are unavailing; not only does sec. 6110(j)(3) provide that private letter rulings cannot be cited as precedent, but, unlike the case at hand, the other party to the transaction in both private letter rulings had the risks of ownership during the relevant time period. Similarly, Rev. Rul. 75-291, 1975-2 C.B. 333, and Rev. Rul. 77-297, 1977-2 C.B. 304, cited in Priv. Ltr. Rul. 78-23-035, don't help petitioners; not only does this Court regard published rulings as having no precedential value, see Estate of Lang v. Commissioner, 613 F.2d 770, 776 [45 AFTR 2d 80-1756] (9th Cir. 1980), affg. on this issue 64 T.C. 404, 406-407 (1975); Intel Corp. & Consol. Subs. v. Commissioner, 102 T.C. 616, 621 (1993); Stark v. Commissioner, 86 T.C. 243, 250-251 (1986), but the facts of both rulings, like Priv. Ltr. Rul. 91-94-018 (Sept. 4, 1991), are distinguishable from the case at hand in the same dispositive respect.

7

We have found no other like-kind exchange cases in the Seventh Circuit that bear on the issue in the case at hand. However, another Seventh Circuit case worth noting is Patton v. Jonas, 249 F.2d 375 [52 AFTR 875] (7th Cir. 1957), which applies the same analysis as the line of Sixth Circuit cases culminating in First Am. Natl. Bank of Nashville v. United States, 467 F.2d 1098 [30 AFTR 2d 72-5601] (6th Cir. 1972), which hold that "repo" transactions in tax-exempt bonds are to be treated as secured loans so that the purchaser in form is treated as a lender not entitled to exclude the tax-exempt bond interest from its income; this is because the original seller remains the owner of the bonds for tax purposes. See also Green v. Commissioner, 367 F.2d 823, 825 [18 AFTR 2d 5813] (7th Cir. 1966), affg. T.C. Memo. 1965-272 [¶65,272 PH Memo TC]; Commercial Capital Corp. v. Commissioner, T.C. Memo. 1968-186 [¶68,186 PH Memo TC]. Compare Rev. Rul. 74-27, 1974-1 C.B. 24 (repurchase obligation) with Rev. Rul. 82-144, 1982-2 C.B. 34 (separately purchased and paid-for put).

8

We also observe that J.H. Baird Publg. Co. v. Commissioner, 39 T.C. 608, 618 (1962), on which petitioners rely, applied the concept of beneficial ownership in the taxpayer's favor. Petitioners have failed to persuade us that the concept of beneficial ownership is an illegitimate importation into the tax law of qualified like-kind exchanges.

9

In so doing, the subject transactions satisfy the requirements for application of what the Court of Appeals for the Seventh Circuit has characterized as the most restrictive and rigorous version of the step-transaction doctrine: the binding commitment test. McDonald's Restaurants, Inc. v. Commissioner, 688 F.2d 520, 525 [50 AFTR 2d 82-5750] (7th Cir. 1982), revg. 76 T.C. 872 (1981).

FIELD OFFICE ANNOUNCEMENT 20050203F

Date:
November 30, 2004

To:-
From: , Attorney LMSB,
Subject:
Taxpayer Corporation Section 1031 Exchange POSTF-151222-04
Taxpayer =
Location AA =
A =
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E =
F =
G =
H =
I =
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Location CC =
Date 4 =
V =
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Date 5 =
Date 6 =
Date 7 =
$ C =
$ D =
Date 8 =
Name 2 =
Location DD =
Date 9 =
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Location EE =
Location FF =
Date 10 =
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$ F =
Date 11 =
$ G =
$ H =
$ I =
$ J =
Date 12 =
$ K =
Name 3 =
Date 13 =
$ L =

Date 14 =

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our view. This memo may not be cited as precedent.

This responds to your request for advice on the draft NOPA for the above taxpayer's taxable year ended Date 12 dealing with the issue set forth below.

ISSUE

Whether Taxpayer's sale and acquisition of property qualifies for like-kind exchange treatment under IRC §1031.

CONCLUSION

If Taxpayer was the beneficial owner of the replacement property before the exchange at issue, then the exchange will not qualify for §1031 like-kind non-recognition. Furthermore, if Taxpayer wishes to argue that it was involved in a "reverse exchange", whereby it "parked" the replacement property with an accommodation party, then it will not find relief under Revenue Procedure 2000-37 because the transaction occurred before the Rev. Proc. effective date. Even if the effective date was not an issue and the Rev. Proc. did apply, the transaction would fail under the specific requirements of the Rev. Proc.

FACTUAL SUMMARY

This summary of the facts is based upon the factual statement in the draft NOPA and other information you provided:

Taxpayer owns and operates "#1" "A" in Location AA. Each store has a "C", offers a variety of consumer goods available for sale (from "D" to "E" to "F" to "G"), and provides "H" and "I". The company has one "J" and "K" for all of its "L". The "B" manages the "M" of the company, including "N", an "O", a "P", and three "Q".

On Date 1 Taxpayer entered into a Purchase and Sale Agreement with Name 1 ("Seller") to purchase property located at Location BB, ("Replacement Property") for the amount of $A. The Agreement provided for Buyer and Seller to cooperate in a Section 1031 exchange, including permitting assignment of the agreement to an exchange facilitator.

On Date 2 Taxpayer guaranteed a Business Loan Agreement in the amount of $ B on behalf of "R". The loan was scheduled to mature on Date 3. "R", is also known as "S", and is a "T". "U" is a Location CC Corporation and is "Y"'s sole member.

On Date 4 Taxpayer amended the Purchase and Sale Agreement dated Date 1 and assigned its rights under the contract to "R", ("S") and entered into a Real Estate Acquisition and Exchange Cooperation Agreement (REAECA) pursuant to which "S" would acquire the replacement property from the Seller. "S" agreed to construct a "V", lease it to Taxpayer until the Exchange took place, and then sell the property to Taxpayer at "Fair Market Value" to effect the Exchange. For the 24 month period beginning after the date on which "S" acquired the replacement property, "Fair Market Value" would be the acquisition costs incurred by "S". According to "W", "S" acquired the property on Date 5. "S"'s responsibility for the improvements was solely to disburse funds approved by Taxpayer. Taxpayer retained the right to purchase the Replacement Property at any time from "S" for cash in an amount equal to the "Fair Market Value", as defined in section 3.2.4 of the REAECA: " "Fair Market Value" of the Replacement Property shall mean the fair market value determined by an appraisal conducted by a nationally recognized real estate appraiser as may be agreed to by Taxpayer and "S" (the "Appraiser"); provided, however, that if the Replacement Property is purchased from "S" within twenty-four (24) months after the date on which "S" acquired the Replacement Property, then the "Fair Market Value" shall be deemed to equal its "Acquisition Cost" as hereinafter defined." Taxpayer was further obligated to pay fees to "S" for its services in connection with the Exchange.

On Date 6 Taxpayer entered into a lease agreement with "S" for a period of 24 months commencing on Date 7 with an option to extend the lease terms. The lease was a "triple net lease", and Taxpayer was responsible for paying for all taxes and insurance costs. Net monthly rent was $ C per month, with total net rent under the lease not to exceed $ D. "Net" rent was defined as the amount of rent owing by Tenant after any offsets for any interest owed by Landlord to Tenant related to the premises.

On Date 8 Taxpayer entered into a Purchase and Sale Agreement with Name 2 for the sale of property located at Location DD ("Relinquished Property").

On Date 9 Taxpayer entered into an Exchange Agreement with "X", a Location AA corporation, to serve as a qualified intermediary to the exchange of the Location EE property ("Relinquished Property") for the Location FF property ("Replacement Property").
Taxpayer reported a disposition of a commercial real estate building on Date 10 for a sales price of $ E and net sales proceeds of $ F. Taxpayer reported an acquisition of a commercial real estate building on Date 11 for a purchase price of $ G plus additional purchase costs of $ H. Payment was made by the escrow funds of $ F and cash payment of $ I. Dates and amounts were evidenced by settlement statements. Taxpayer reported on Form 8824, Like-Kind Exchanges, deferred gain of $ J for tax year ended Date 12.

DISCUSSIONGeneral Principles

I.R.C. § 1031(a)(1) provides that no gain or loss will be 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 a like kind which is to be held either for productive use in a trade or business or for investment.

When the exchange is not simultaneous, the Code imposes an additional requirement. Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) of the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

The regulations provide further guidance for deferred exchanges. Section 1.1031(k)-1 specifies in detail the circumstances in which deferred exchanges will be accorded nonrecognition treatment. Specifically omitted from such guidance is any application of these regulations to "reverse exchanges." T.D. 8346, 1991-1 C.B. 150, 151 (April 25, 1991).

On September 15, 2000, the Service issued Rev. Proc. 2000-37, 2000- 40 I.R.B. 308, setting forth a safe harbor for reverse like-kind exchanges under § 1031. Under the Rev. Proc. 2000-37 safe harbor provisions, so long as replacement property is properly identified within 45 days and so long as the transaction is completed within 180 days, the Service will not challenge either (a) the qualification of the property as either replacement or relinquished property (as defined in Treas. Reg. § 1.1031(k)-1(a)) or (b) the treatment of the exchange accommodation titleholder as the beneficial owner if the property is held in a "qualified exchange accommodation arrangement" (QEAA).

Rev. Proc. 2000-37 is effective for QEAAs entered into on or after September 15, 2000. Rev. Proc. 2000-37 provides that "no inference" is intended with respect to the federal income tax treatment of similar arrangements entered into prior to or after its effective date. Further, the Service stated that it recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in the revenue procedure. §3.02 of Rev. Proc. 2000-37.

Rev. Proc. 2000-37 does not apply to Taxpayer's transaction. First, "S"'s acquisition of the replacement property predates the effective date of Rev. Proc. 2000-37. Second, even if Rev. Proc. 2000-37 applied to the transaction, "S" acquired the replacement property more than 180 days before the transfer to Taxpayer. Additionally, there is still some ambiguity as to whether the relinquished property was properly identified in the required 45 day period.

Benefits and Burdens AnalysisIf the facts demonstrate that Taxpayer was the beneficial owner of the replacement property, then Section 1031 does not apply, as Taxpayer cannot effectuate a tax deferred exchange with itself. *DeCleene v. Commissioner*, 115 T.C. 457, 469 (2000). The Tax Court generally considers the following factors when determining whether the benefits and burdens of ownership have passed to a purchaser: (1) whether legal title passes;(2) whether the parties treat the transaction as a sale;(3) whether the purchaser acquires an equity interest in the property;(4) whether the sales contract creates an obligation on the part of the seller to execute and deliver a deed and an obligation on the purchaser to make payments;(5) whether the purchaser is vested with the right of possession;(6) whether the purchaser pays income and property taxes;(7) whether the purchaser bears the risk of economic loss or physical damage; and(8) whether the purchaser receives a profit from the operation, retention and sale of the property. See *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, at 1237-38 (1981). These factors are applied to the facts of this case below.

1. *Whether legal title passes.* Here, the relevant documents indicate that legal title passed to "S".

2. *Whether the parties treat the transaction as a sale.*Here, as a result of the REAECA, "S" acquired the right to complete the sale, which presumably it did.

3. *Whether the purchaser acquires an equity interest in the property.* Here, Taxpayer, and not "S" was entitled to the equity in the replacement property for the first twenty-four months beginning with the date of acquisition. If the value of the replacement property went up, Taxpayer was entitled, through the terms of the agreement, to the difference between the acquisition cost and the fair market value of the property for twenty-four months beginning after the day "S" acquired the property. Furthermore, "S" had no risk of loss, since the property was purchased with borrowed funds guaranteed by Taxpayer.

4. *Whether the sales contract obligates the seller to execute and deliver a deed and obligates the purchaser to make payments.* Presumably, in taking legal title, "S" received the deed to replacement property and was obligated to make payments to the seller. In actuality, however, those payments were made from loan proceeds guaranteed by Taxpayer, not "S". Moreover, the REAECA explicitly excused "S" from having to make any payment for replacement property in excess of the funds supplied by the loan proceeds or proceeds from the sale of relinquished property. (See 2.2 of REAECA)

5. *Whether the purchaser is vested with the right of possession.* Here, the terms of the REAECA actually gave Taxpayer the right to lease, and therefore possess, the property. "S" merely possessed the title to the property and never actually had the right to occupy it.

6. *Whether the purchaser pays property taxes after the transaction.* As a result of the triple net lease, Taxpayer, not "S" was obliged to pay property taxes after the transaction.

7. *Whether the purchaser bears the risk of economic loss or physical damage.* Here, "S" had no risk of loss associated with the replacement property. Ultimately, since the note was guaranteed by Taxpayer, "S" had no risk associated with any decline in value or damage to the replacement property. This risk was entirely Taxpayer's. Liability for operating the property also rested with Taxpayer under the terms of the lease. Taxpayer was responsible for obtaining liability insurance that named "S" as an additional insured party.

Additionally, "S" issued a promissory note to the Taxpayer on Date 13 for $ L, payable on Date 12. This note was presumably for "S"'s use to pay the interest on the original note between "S" and the bank. Again, this arrangement supports the notion that "S" bore no responsibility or risk for any economic loss or physical damage with respect to the property. Indeed, it appears as though "S" acted merely as a filter, through which these payments on the note were made. Under these circumstances, it appears that Taxpayer, and not "S", was the beneficial owner of the property.

Whether the purchaser receives a profit from the property. Here, Taxpayer was entitled to the profit from the sale of the property. "S" was not entitled to sell the property under the terms of the REAECA unless Taxpayer gave its consent. Taxpayer, however, was allowed to purchase the property from "S" at the acquisition cost at any time for twenty-four months after the date "S" acquired it. Therefore, if the value of the property went up during this period, Taxpayer, not "S", was entitled to the profits. The only way that "S" could potentially receive any profit from the property would be if the following sequence of events occurred: 1. Taxpayer failed to consummate the exchange, 2. "S" sends an "Exchange Termination Notice" to Taxpayer within 60 days after the expiration of the Contract Period, and 3. Taxpayer does not exercise its purchase option.

An additional issue with respect to the profits interest in the property involves the lease back to the Taxpayer. The terms of the lease provided that Taxpayer would pay $ C per month for the lease. An appraisal of the fair market rental value conducted by an IRS appraiser shows that a property of the type and size at issue would fairly rent for somewhere between $ K per month. This extraordinary disparity in the negotiated rent is evidence that "S" never actually received any of the equitable benefit of owning the property. Instead, the rent that "S" received covered the expenses of warehousing the property, not the fair rental value of the property.

In an undated letter received regarding your IDR #12, Name 3, the General Counsel of "U", the sole member of "R", explained that the purpose of the negotiated rent payment was to "compensate Landlord for the risks of ownership of the replacement property." No mention is made of an actual business purpose or fair rental value of the property. This strongly suggests that "S" had no beneficial ownership interest in the property, since it served as landlord without receiving a profit or even fair market rental value.

Under this analysis, Taxpayer may have been the beneficial owner of the property for federal tax purposes, even though "S" held the legal title. A court will look at all of the facts and circumstances, and consider all of the factors together. Here, the only factors that appear to favor "S" are numbers 1 and 2. The remaining factors suggest that Taxpayer is the true owner of the property.

The only benefit it appears that "S" got was its fee, as described in Section 12 of the REAECA. "S" was not entitled to share any of the gain resulting from the sale of the property, nor was it obligated by any potential loss in value of the property. Therefore, it appears that Taxpayer was entitled to all of the economic benefits and burdens of ownership.

Application of Revenue Procedure 2000-37

Taxpayer is not claiming that the transaction is a reverse- exchange. If, however, Taxpayer wished to try this approach, no relief would be available under the safe harbor of Rev. Proc. 2000-37, because the transaction would have taken place before the effective date of the Rev. Proc. The transaction occurred in Date 14, and the Rev. Proc. is not effective for transactions occurring before September 15, 2000.

Even if, however, the effective date were not an issue, Taxpayer would still fail the requirements of the safe harbor. The Rev. Proc. outlines that the exchange must be completed within 180 days of the transfer of replacement property to the exchange accommodation titleholder. Taxpayer was clearly outside of this time period. Furthermore, the discrepancy with respect to the identification of relinquished property may also disqualify Taxpayer from the safe harbor.

[Redacted Text]

If I can be of any further assistance, then please do not hesitate to contact me.

Sincerely,

[Redacted Text]

Attorney

REVENUE RULING 2004-51

ISSUES

1. Whether, under the facts described below, an organization continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) of the Internal Revenue Code when it contributes a portion of its assets to and conducts a portion of its activities through a limited liability company (LLC) formed with a for-profit corporation.

2. Whether, under the same facts, the organization is subject to unrelated business income tax under § 511 on its distributive share of the LLC's income.

FACTS

M is a university that has been recognized as exempt from federal income tax under § 501(a) as an organization described in § 501(c)(3). As a part of its educational programs, *M* offers summer seminars to enhance the skill level of elementary and secondary school teachers.

To expand the reach of its teacher training seminars, *M* forms a domestic LLC, *L*, with *O*, a company that specializes in conducting interactive video training programs. *L*'s Articles of Organization and Operating Agreement ("governing documents") provide that the sole purpose of *L* is to offer teacher training seminars at off-campus locations using interactive video technology. *M* and *O* each hold a 50 percent ownership interest in *L*, which is proportionate to the value of their respective capital contributions to *L*. The governing documents provide that all returns of capital, allocations and distributions shall be made in proportion to the members' respective ownership interests.

The governing documents provide that *L* will be managed by a governing board comprised of three directors chosen by *M* and three directors chosen by *O*. Under the governing documents, *L* will arrange and conduct all aspects of the video teacher training seminars, including advertising, enrolling participants, arranging for the necessary facilities, distributing the course materials and broadcasting the seminars to various locations. *L*'s teacher training seminars will cover the same content covered in the seminars *M* conducts on *M*'s campus. However, school teachers will participate through an interactive video link at various locations rather than in person. The governing documents grant *M* the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars. The governing documents grant *O* the exclusive right to select the locations where participants can receive a video link to the seminars and to approve other personnel (such as camera operators) necessary to conduct the video teacher training seminars. All other actions require the mutual consent of *M* and *O*.

The governing documents require that the terms of all contracts and transactions entered into by *L* with *M*, *O* and any other parties be at arm's length and that all contract and transaction prices be at fair market value determined by reference to the prices for comparable goods or services. The governing documents limit *L*'s activities to conducting the teacher training seminars and also require that L not engage in any activities that would jeopardize *M*'s exemption under § 501(c)(3). *L* does in fact operate in accordance with the governing documents in all respects.

M's participation in *L* will be an insubstantial part of *M*'s activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.

Because *L* does not elect under § 301.7701-3(c) of the Procedure and Administration Regulations to be classified as an association, *L* is classified as a partnership for federal tax purposes pursuant to § 301.7701-3(b).

LAW

Exemption under § 501(c)(3)

Section 501(c)(3) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of the exempt purposes specified in § 501(c)(3). Activities that do not further exempt purposes must be an insubstantial part of the organization's activities. In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945), the Supreme Court held that "the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To meet this requirement, an organization must "establish that it is not organized or operated for the benefit of private interests...."

Section 1.501(c)(3)-1(d)(2) defines the term "charitable" as used in § 501(c)(3) as including the advancement of education.

Section 1.501(c)(3)-1(d)(3)(i) provides, in part, that the term "educational" as used in § 501(c)(3) relates to the instruction or training of the individual for the purpose of improving or developing his capabilities.

Section 1.501(c)(3)-1(d)(3)(ii) provides examples of educational organizations including a college that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on and an organization that presents a course of instruction by means of correspondence or through the utilization of television or radio.

Joint Ventures

Rev. Rul. 98-15, 1998-1 C.B. 718, provides that for purposes of determining exemption under § 501(c)(3), the activities of a partnership, including an LLC treated as a partnership for federal tax purposes, are considered to be the activities of the partners. A § 501(c)(3) organization may form and participate in a partnership and meet the operational test if 1) participation in the partnership furthers a charitable purpose, and 2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.

Redlands Surgical Services, 113 T.C. 47, 92-93 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001), provides that a nonprofit organization may form partnerships, or enter into contracts, with private parties to further its charitable purposes on mutually beneficial terms, "so long as the nonprofit organization does not thereby impermissibly serve private interests." The Tax Court held that the operational standard is not satisfied merely by establishing "whatever charitable benefits [the partnership] may produce," finding that the nonprofit partner lacked "formal or informal control sufficient to ensure furtherance of charitable purposes." Affirming the Tax Court, the Ninth Circuit held that ceding "effective control" of partnership activities impermissibly serves private interests. 242 F.3d at 904.

St. David's Health Care System v. United States, 349 F.3d 232, 236-237 (5th Cir. 2003), held that the determination of whether a nonprofit organization that enters into a partnership operates exclusively for exempt purposes is not limited to "whether the partnership provides some (or even an extensive amount of) charitable services." The nonprofit partner also must have the "capacity to ensure that the partnership's operations further charitable purposes." *Id*. at 243. "[T]he non-profit should lose its tax-exempt status if it cedes control to the for-profit entity." *Id*. at 239.

Tax on Unrelated Business Income

Section 511(a), in part, provides for the imposition of tax on the unrelated business taxable income (as defined in § 512) of organizations described in § 501(c)(3).

Section 512(a)(1) defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it less the deductions allowed, both computed with the modifications provided in § 512(b).

Section 512(c) provides that, if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to the organization, in computing its unrelated business taxable income, the organization shall, subject to the exceptions, additions, and limitations contained in § 512(b), include its share (whether or not distributed) of the gross income of the partnership from the unrelated trade or business and its share of the partnership deductions directly connected with the gross income.

Section 513(a) defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501.

Section 1.513-1(d)(2) provides that a trade or business is "related" to an organization's exempt purposes only if the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is "substantially related" for purposes of § 513, only if the causal relationship is a substantial one. Thus, to be substantially related, the activity "must contribute importantly to the accomplishment of [exempt] purposes." Section 1.513-1(d)(2). Section 513, therefore, focuses on "the manner in which the exempt organization operates its business" to determine whether it contributes importantly to the organization's charitable or educational function. *United States v. American College of Physicians*, 475 U.S. 834, 849 (1986).

ANALYSIS

L is a partnership for federal tax purposes. Therefore, *L*'s activities are attributed to *M* for purposes of determining both whether *M* operates exclusively for educational purposes and therefore continues to qualify for exemption under § 501(c)(3) and whether *M* has engaged in an unrelated trade or business and therefore may be subject to the unrelated business income tax on its distributive share of *L*'s income.

The activities *M* is treated as conducting through *L* are not a substantial part of *M*'s activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1). Therefore, based on all the facts and circumstances, *M*'s participation in *L*, taken alone, will not affect *M*'s continued qualification for exemption as an organization described in § 501(c)(3).

Although *M* continues to qualify as an exempt organization described in § 501(c)(3), *M* may be subject to unrelated business income tax under § 511 if *L* conducts a trade or business that is not substantially related to the exercise or performance of *M*'s exempt purposes or functions.

The facts establish that *M*'s activities conducted through *L* constitute a trade or business that is substantially related to the exercise and performance of *M*'s exempt purposes and functions. Even though *L* arranges and conducts all aspects of the teacher training seminars, *M* alone approves the curriculum, training materials and instructors, and determines the standards for successfully completing the seminars. All contracts and transactions entered into by *L* are at arm's length and for fair market value, *M*'s and *O*'s ownership interests in *L* are proportional to their respective capital contributions, and all returns of capital, allocations and distributions by *L* are proportional to *M*'s and *O*'s ownership interests. The fact that *O* selects the locations and approves the other personnel necessary to conduct the seminars does not affect whether the seminars are substantially related to *M*'s educational purposes. Moreover, the teacher training seminars *L* conducts using interactive video technology cover the same content as the seminars *M* conducts on *M*'s campus. Finally, *L*'s activities have expanded the reach of *M*'s teacher training seminars, for example, to individuals who otherwise could not be accommodated at, or conveniently travel to, *M*'s campus. Therefore, the manner in which *L* conducts the teacher training seminars contributes importantly to the accomplishment of *M*'s educational purposes, and the activities of *L* are substantially related to *M*'s educational

purposes. Section 1.513-1(d)(2). Accordingly, based on all the facts and circumstances, *M* is not subject to unrelated business income tax under § 511 on its distributive share of *L*'s income.

HOLDINGS

1. *M* continues to qualify for exemption under § 501(c)(3) when it contributes a portion of its assets to and conducts a portion of its activities through *L*.

2. *M* is not subject to unrelated business income tax under § 511 on its distributive share of *L*'s income.

DRAFTING INFORMATION

The principal author of this revenue ruling is Virginia G. Richardson of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Virginia G. Richardson at (202) 283-8938 (not a toll-free call).

REVENUE PROCEDURE 2005-27

SECTION 1. PURPOSE AND NATURE OF CHANGES

.01 This revenue procedure provides an updated list of time-sensitive acts, the performance of which may be postponed under sections 7508 and 7508A of the Internal Revenue Code (Code). Section 7508 of the Code postpones the time to perform specified acts for individuals serving in the Armed Forces of the United States or serving in support of such Armed Forces, in a combat zone, or serving with respect to a contingency operation (as defined in 10 U.S.C. 101(a)(3)). Section 7508A of the Code permits a postponement of the time to perform specified acts for taxpayers affected by a Presidentially declared disaster or a terroristic or military action. The list of acts in this revenue procedure supplements the list of postponed acts in section 7508(a)(1) of the Code and section 301.7508A-1(b) of the Regulations on Procedure and Administration.

.02 This revenue procedure does not, by itself, provide any postponements under section 7508A. In order for taxpayers to be entitled to a postponement of any act listed in this revenue procedure, the IRS generally will publish a Notice or issue other guidance (including an IRS News Release) providing relief with respect to a Presidentially declared disaster, or a terroristic or military action.

.03 For purposes of section 7508, this revenue procedure sets forth such other acts as contemplated by section 7508(a)(1)(K). Unlike section 7508A, when a taxpayer qualifies under section 7508, all the acts listed in section 7508(a)(1) are postponed. Therefore, when a taxpayer qualifies under section 7508, the acts listed in this revenue procedure are also postponed for that taxpayer, whether or not the IRS publishes a Notice or issues other guidance.

.04 This revenue procedure will be updated as needed when the IRS determines that additional acts should be included in the list of postponed acts or that certain acts should be removed from the list. Also, taxpayers may recommend that additional acts be considered for postponement under sections 7508 and 7508A. *See* section 19 of this revenue procedure.

.05 Significant Changes

(1) This Revenue Procedure clarifies that the acts listed below are automatically postponed for taxpayers afforded relief pursuant to section 7508.

(2) New section 17 expands the categories of taxpayers qualifying for relief, and provides additional postponements of deadlines solely with respect to section 1031 like-kind exchange transactions that are affected by a Presidentially declared disaster.

SECTION 2. BACKGROUND

.01 Section 7508(a)(1) of the Internal Revenue Code permits a postponement of certain time-sensitive acts for individuals serving in the Armed Forces or in support of such Armed Forces in an area designated by the President as a combat zone under section 112 or serving with respect to a contingency operation (as defined in 10 U.S.C. 101(a)(3)). Among these acts are the filing of returns, the payment of tax, the filing of a Tax Court petition, and the filing of a refund claim. In the event of service in a combat zone or service with respect to a contingency operation, the acts specified in section 7508(a)(1) of the Code are *automatically postponed*. This revenue procedure sets forth such other acts as contemplated by section 7508(a)(1)(K). Thus, the acts listed in this revenue procedure are also automatically postponed. In addition, the Service may include acts not listed in this revenue procedure in any other published guidance (including an IRS News Release) related to the combat zone or contingency operation.

.02 Section 7508A of the Code provides that certain acts performed by taxpayers and the government may be postponed if the taxpayer is affected by a Presidentially declared disaster or a terroristic or military action. A "Presidentially declared disaster" is defined in section 1033(h)(3) of the Code. A "terroristic or military action" is defined in section 692(c)(2) of the Code. Section 301.7508A-1(d)(1) of the regulations defines seven types of affected taxpayers, including any individual whose principal residence (for purposes of section 1033(h)(4)) is located in a "covered disaster area" and any business entity or sole proprietor whose principal place of business is located in a "covered disaster area." Postponements under section 7508A are not available simply because a disaster or a terroristic or military action has occurred. Generally, the IRS will publish a Notice or issue other guidance (including an IRS News Release) authorizing the postponement. Such guidance will describe the *acts* postponed, the *duration* of the postponement, and the *location* of the covered disaster area. *See*, for example, Notice 2001-68, 2001-2 C.B. 504, *supplementing* Notice 2001-61, 2001-2 C.B. 305. When a Notice or other guidance for a particular disaster is published, or issued, the guidance generally will refer to this revenue procedure and may provide for a postponement of all the acts listed in the regulations and this revenue procedure. Alternatively, the guidance may provide that only certain acts listed in this revenue procedure are postponed based on the time when the disaster occurred, its severity, and other factors.

SECTION 3. SCOPE

This revenue procedure applies to individuals serving in the Armed Forces in a combat zone, or in support of such Armed Forces, individuals serving with respect to contingency operations, affected taxpayers by reason of Presidentially declared disasters within the meaning of section 301.7508A-1(d)(1) of the regulations, and taxpayers whom the IRS determines are affected by a terroristic or military action.

SECTION 4. APPLICATION

.01 The tables below list provisions of the internal revenue laws requiring the timely performance of specified acts that may be postponed under sections 7508 and 7508A. In addition, section 17 of this revenue procedure expands the categories of taxpayers qualifying for relief and provides additional postponements of deadlines solely with respect to section 1031 like-kind exchange transactions that are affected by a Presidentially declared disaster. Taxpayers may use the postponement rules provided in section 17 in lieu of the general extension dates provided by an IRS News Release or other guidance issued with respect to a specific Presidentially declared disaster. Taxpayers who are covered by the rules of section 17, but who are not

otherwise treated as "affected taxpayers" by the IRS News Release or other guidance or section 301.7508A-1(d)(1) are not eligible for relief under section 7508A, except for the relief for section 1031 like-kind exchanges.

.02 In order to avoid unnecessary duplication, the following tables do not include acts specified in sections 7508 or 7508A or the regulations thereunder. Thus, for example, no mention is made in the following tables of the filing of tax returns or the payment of taxes (or an installment thereof) because these acts are already covered by sections 7508 and 7508A and the regulations thereunder. Also, the following tables do not refer to the making of accounting method elections or any other elections required to be made on tax returns or attachments thereto. Reference to these elections is not necessary because postponement of the filing of a tax return automatically postpones the making of any election required to be made on the return or an attachment thereto.

.03 The following tables refer only to postponement of acts performed by taxpayers. Additional guidance will be published in the Internal Revenue Bulletin if a decision is made that acts performed by the government may be postponed under section 7508A.

SECTION 5. ACCOUNTING METHODS AND PERIODS

	Statute or Regulation	Act Postponed
1.	Chapter 1, Subchapter E of the Code	Any act relating to the adoption, election, retention, or change of any accounting method or accounting period, or to the use of an accounting method or accounting period, that is required to be performed on or before the due date of a tax return (including extensions). Examples of such acts include (a) the requirements in Rev. Procs. 2002-37, 2002-1 C.B. 1030, 2002-38, 2002-1 C.B. 1037 and 2002-39, 2002-1 C.B. 1046, and 2003-62, 2003-2 C.B. 299, that Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, be filed with the Director, Internal Revenue Service Center, on or before the due date (or the due date including extensions) of the tax return for the short period required to effect the change in accounting period; and (b) the requirement in Rev. Proc. 2002-9, 2002-1 C.B. 327, section 6.02 (3) that a copy of Form 3115 must be filed with the national office no later than when the original Form 3115 is filed with the timely filed tax return for the year of the accounting method change.
2.	Treas. Reg. § 1.381(c)(4)-1(d)(2)	If the acquiring corporation is not permitted to use the method of accounting used by the acquiring corporation, the method of accounting used by the distributor/transferor corporation, or the principal method of accounting; or if the corporation wishes to use a new method of accounting, then the acquiring corporation must apply to the Commissioner to use another method. Section 1.381(c)(4)-1(d)(2) requires applications to be filed not later than 90 days after the date of distribution or transfer. Rev. Proc. 83-77, 1983-2 C.B. 594, provides an automatic 90-day extension.
3.	Treas. Reg. § 1.381(c)(5)-1(d)(2)	If the acquiring corporation is not permitted to use the inventory method used by the acquiring corporation, the inventory method used by the distributor/transferor corporation, or the principal method of accounting, or wishes to use a new method of accounting, then the acquiring corporation must apply to the Commissioner to use another method. Section 1.381(c)(5)-1(d)(2) requires applications to be filed not later than 90 days after the date of distribution or transfer. Rev. Proc. 83-77 provides an automatic 90-day extension.
4.	Treas. Reg. § 1.442-1(b)(1)	In order to secure prior approval of an adoption, change, or retention of a taxpayer's annual accounting period, the taxpayer generally must file an application on Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, with the Commissioner within such time as is provided in administrative procedures published by the Commissioner from time to time. *See*, for example, Rev. Procs. 2002-37, 2002-38, 2002-39 and 2003-62.
5.	Treas. Reg. § 1.444-3T(b)(1)	A section 444 election must be made by filing Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year*, with the Service Center. Generally, Form 8716 must be filed by the earlier of (a) the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or (b) the due date (without regard to extensions) of the income tax return resulting from the section 444 election.
6.	Treas. Reg. § 1.446-1(e)(2)(i)	Section 6 of Rev. Proc. 2002-9, 2002-1 C.B. 327, 341, allows a taxpayer to change a method of accounting within the terms of the revenue procedure by attaching the application form to the timely filed return for the year of change. Section 6.02(3)(b) grants an automatic extension of 6 months within which to file an amended return with the application for the change following a timely filed original return for the year of change.
7.	Treas. Reg. § 1.446-1(e)(3)(i)	To secure the Commissioner's consent to a change in method of accounting, the taxpayer must file an application on Form 3115, *Application for Change in Accounting Method*, with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting (*i.e.*, must be filed by the last day of such taxable year). This filing requirement is also in Rev. Proc. 97-27, 1997-1 C.B. 680. (*But see* Rev. Proc. 2002-9 for automatic changes in method of accounting that can be made with the return.)
8.	Sec. 451(e)	Section 451(e) permits a taxpayer using the cash receipts and disbursements method of accounting who derives income from the sale or exchange of livestock in excess of the number he would sell if he followed his usual business practices to elect (which election is deemed valid if made within the period described in section 1033(e)(2)) to include such income for the taxable year following the taxable year of such sale or exchange if, under his usual business practices, the sale or exchange would not have occurred if it were not for drought, flood, or other weather-related conditions and that such conditions resulted in the area being designated as eligible for Federal assistance.
9.	Treas. Reg. § 1.461-1(c)(3)(ii)	A taxpayer may elect, with the consent of the Commissioner, to accrue real property taxes ratably in accordance with section 461(c). A written request for permission to make such an election must be submitted within 90 days after the beginning of the taxable year to which the election is first applicable. Rev. Proc. 83-77 provides an automatic 90-day extension.
10.	Treas. Reg. § 1.7519-2T(a)(2), (3) and (4)	A partnership or S corporation must file the Form 8752, *Required Payment or Refund Under Section 7519*, if the taxpayer has made an election under section 444 to use a taxable year other than its required taxable year and the election is still in effect. The Form 8752 must be filed and any required payment must be made by the date stated in the instructions to Form 8752.

	Statute or Regulation	Act Postponed
11.	Rev. Proc. 92-29, Section 6.02	A developer of real estate requesting the Commissioner's consent to use the alternative cost method must file a private letter ruling request within 30 days after the close of the taxable year in which the first benefited property in the project is sold. The request must include a consent extending the period of limitation on the assessment of income tax with respect to the use of the alternative cost method.

SECTION 6. BUSINESS AND INDIVIDUAL TAX ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 1.71-1T(b), Q&A-7	A payer spouse may send cash to a third party on behalf of a spouse that qualifies for alimony or separate maintenance payments if the payments are made to the third party at the written request or consent of the payee spouse. The request or consent must state that the parties intend the payment to be treated as an alimony payment to the payee spouse subject to the rules of section 71. The payer spouse must receive the request or consent prior to the date of filing of the payer spouse's first return of tax for the taxable year in which the payment was made.
2.	Treas. Reg. § 1.77-1	A taxpayer who receives a loan from the Commodity Credit Corporation may elect to include the amount of the loan in his gross income for the taxable year in which the loan is received. The taxpayer in subsequent taxable years must include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Section 1.77-1 requires such requests to be filed within 90 days after the beginning of the taxable year of change. Rev. Proc. 83-77 provides an automatic 90-day extension.
3.	Treas. Reg. § 1.110-1(b)(4)(ii)(A)	The lessee must expend its construction allowance on the qualified long-term real property within eight and one-half months after the close of the taxable year in which the construction allowance was received.
4.	Sec. 118(c)(2)	A contribution in aid of construction received by a regulated public utility that provides water or sewerage disposal services must be expended by the utility on qualifying property before the end of the second taxable year after the year in which it was received by the utility.
5.	Treas. Reg. § 1.170A-5(a)(2)	A contribution of an undivided present interest in tangible personal property shall be treated as made upon receipt by the donee of a formally executed and acknowledged deed of gift. The period of initial possession by the donee may not be deferred for more than one year.
6.	Sec. 172(b)(3)	A taxpayer entitled to a carryback period under section 172(b)(1) may elect to relinquish the entire carryback period. The taxpayer must make the election by the due date of the taxpayer's federal income tax return (including extensions) for the taxable year of the net operating loss for which the election is to be effective.
7.	Sec. 172(f)(6)	A taxpayer entitled to a 10-year carryback under section 172(b)(1)(C) (relating to certain specified liability losses) from any loss year may elect to have the carryback period with respect to such loss year determined without regard to that section. The taxpayer must make the election by the due date of the taxpayer's federal income tax return (including extensions) for the taxable year of the net operating loss.
8.	Sec. 172(i)(3)	A taxpayer entitled to a 5-year carryback period under section 172(b)(1)(G) (relating to certain farming losses) from any loss year may elect to have the carryback period with respect to such loss year determined without regard to that section. The taxpayer must make the election by the due date of the taxpayer's federal income tax return (including extensions) for the taxable year of the net operating loss.
9.	Sec. 468A(g)	A taxpayer that makes payments to a nuclear decommissioning fund with respect to a taxable year must make the payments within $2^1/_2$-months after the close of such taxable year (the deemed payment date).
10.	Treas. Reg. § 1.468A-3(h)(1)(v)	A taxpayer must file a request for a schedule of ruling amounts for a nuclear decommissioning fund by the deemed payment date ($2^1/_2$-months after the close of the taxable year for which the schedule of ruling amounts is sought).
11.	Treas. Reg. § 1.468A-3(h)(1)(vii)	A taxpayer has 30 days to provide additional requested information with respect to a request for a schedule of ruling amounts. If the information is not provided within the 30 days, the request will not be considered filed until the date the information is provided.
12.	Sec. 530(h)	A trustee of a Coverdell education savings account must provide certain information concerning the account to the beneficiary by January 31 following the calendar year to which the information relates. In addition, Form 5498, *Individual Retirement Arrangement Contribution Information*, must be filed with the IRS by May 31 following the calendar year to which the information relates.
13.	Sec. 563(a)	In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the $3^1/_2$-month period within which the dividend is paid is the period extended.
14.	Sec. 563(b)	In the determination of the dividends paid deduction for purposes of the personal holding company tax imposed by section 541, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall, to the extent the taxpayer elects on its return for the taxable year, be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the $3^1/_2$-month period within which the dividend is paid is the period extended.
15.	Sec. 563(c)	In the determination of the dividends paid deduction for purposes of part III, a dividend paid after the close of any taxable year

	Statute or Regulation	Act Postponed
		and on or before the 15th day of the third month following the close of such taxable year shall, to the extent the company designates such dividend as being taken into account, be considered as paid during such taxable year. The close of the taxable year is not affected by this revenue procedure; the $3^1/_2$-month period within which the dividend is paid is the period extended.
16.	Sec. 563(d)	For the purpose of applying section 562(a), with respect to distributions under subsection (a), (b), or (c) of section 562, a distribution made after the close of the taxable year and on or before the 15th day of the third month following the close of the taxable year shall be considered as made on the last day of such taxable year. The close of the taxable year is not affected by this revenue procedure; the $3^1/_2$-month period within which the dividend is paid is the period extended.
17.	Sec. 529 (c)(3)(C)(i)	A rollover contribution to another qualified tuition program must be made no later than the 60th day after the date of a distribution from a qualified tuition program.
18.	Sec. 530(d)(4)(C)(i)	Excess contributions to a Coverdell education savings account must be distributed before a specified time in the taxable year following the taxable year in which the contribution is made.
19.	Sec. 530(d)(5)	A rollover contribution to another Coverdell education savings account must be made no later than the 60th day after the date of a payment or distribution from a Coverdell education savings account.
20.	Sec. 1031(a)(3)	In a deferred exchange, property otherwise qualified as like-kind property under section 1031 is treated as like-kind property if the 45-day identification period and the 180-day exchange period requirements under section 1031(a)(3) and section 1.1031(k)-1(b)(2) are met. *See also* section 17 of this revenue procedure.
21.	Sec. 1031	Property held in a qualified exchange accommodation arrangement may qualify as "replacement property" or "relinquished property" under section 1031 if the requirements of section 4 of Rev. Proc. 2000-37, 2000-2 C.B. 308, modified by Rev. Proc. 2004-51, 2004-33 I.R.B. 294, are met, including the 5-business day period to enter into a qualified exchange accommodation agreement (QEAA), the 45-day identification period, the 180-day exchange period, and the 180-day combined time period. *See also* section 17 of this revenue procedure.
22.	Sec. 1033	An election respecting the nonrecognition of gain on the involuntary conversion of property (section 1.1033(a)-2(c)(1) and (2)) is required to be made within the time periods specified in section 1.1033(a)-2(c)(3), section 1.1033(g)-1(c), section 1033(e)(2)(A), or section 1033(h)(1)(B), as applicable.
23.	Sec. 1043(a)	If an eligible person (as defined under section 1043(b)) sells any property pursuant to a certificate of divestiture, then at the election of the taxpayer, gain from such sale shall be recognized only to the extent that the amount realized on such sale exceeds the cost of any permitted property purchased by the taxpayer during the 60-day period beginning on the date of such sale.
24.	Sec. 1045(a)	A taxpayer other than a corporation may elect to roll over gain from the sale of qualified small business stock held for more than six months if other qualified small business stock is purchased by the taxpayer during the 60-day period beginning on the date of sale.
25.	Sec. 1382(d)	An organization, to which section 1382(d) applies, is required to pay a patronage dividend within $8^1/_2$-months after the close of the year.
26.	Sec. 1388(j)(3)(A)	Any cooperative organization that exercises its option to net patronage gains and losses, is required to give notice to its patrons of the netting by the 15th day of the 9th month following the close of the taxable year.
27.	Treas. Reg. § 301.7701-3(c)	The effective date of an entity classification election (Form 8832, *Entity Classification Election*) cannot be more than 75 days prior to the date on which the election is filed.
28.	Treas. Reg. § 301.9100-2(a)(1)	An automatic extension of 12 months from the due date for making a regulatory election is granted to make certain elections, including the election to use other than the required taxable year under section 444, and the election to use LIFO under section 472.
29.	Treas. Reg. §§ 301.9100-2(b)-(d)	An automatic extension of 6 months from the due date of a return, excluding extensions, is granted to make the regulatory or statutory elections whose due dates are the due date of the return or the due date of the return including extensions (for example, a taxpayer has an automatic 6 month extension to file an application to change a method of accounting under Rev. Proc. 2002-9), provided the taxpayer (a) timely filed its return for the year of election, (b) within that 6-month extension period, takes the required corrective action to file the election in accordance with the statute, regulations, revenue procedure, revenue ruling, notice or announcement permitting the election, and (c) writes at the top of the return, statement of election or other form "FILED PURSUANT TO section 301.9100-2."

SECTION 7. CORPORATE ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 302(e)(1)	A corporation must complete a distribution in pursuance of a plan of partial liquidation of a corporation within the specified period.
2.	Sec. 303 and Treas. Reg. § 1.303-2	A corporation must complete the distribution of property to a shareholder in redemption of all or part of the stock of the corporation which (for Federal estate tax purposes) is included in determining the estate of a decedent. Section 303 and section 1.303-2 require, among other things, that the distribution occur within the specified period.
3.	Sec. 304(b)(3)(C)	If certain requirements are met, section 304(a) does not apply to a transaction involving the formation of a bank holding company. One requirement is that within a specified period (generally 2 years) after control of a bank is acquired, stock constituting control of the bank is transferred to a bank holding company in connection with the bank holding company's formation.
4.	Sec. 316(b)(2)(A)	A personal holding company may designate as a dividend to a shareholder all or part of a distribution in complete

	Statute or Regulation	Act Postponed
	and (B)(ii) and Treas. Reg. § 1.316-1(b)(2) and (5)	liquidation described in section 316(b)(2)(B) and section 1.316-1(b) by, *inter alia*, including such amount as a dividend in Form 1099-DIV, *Dividends and Distributions*, filed in respect of such shareholder pursuant to section 6042(a) and the regulations thereunder and in a written statement of dividend payments furnished to such shareholder pursuant to section 6042(c) and section 1.6042-4.
5.	Sec. 332(b) and Treas. Reg. §§ 1.332-3 and 1.332-4	A corporation must completely liquidate a corporate subsidiary within the specified period.
6.	Sec. 338(d)(3) and (h), and Treas. Reg. § 1.338-2	An acquiring corporation must complete a "qualified stock purchase" of a target corporation's stock within the specified acquisition period.
7.	Sec. 338(g) and Treas. Reg. § 1.338-2	An acquiring corporation may elect to treat certain stock purchases as asset acquisitions. The election must be made within the specified period.
8.	Sec. 338(h)(10) and Treas. Reg. § 1.338(h)(10)-1(c)	An acquiring corporation and selling group of corporations may elect to treat certain stock purchases as asset purchases, and to avoid gain or loss upon the stock sale. The election must be made within the specified period.
9.	Treas. Reg. § 1.381(c)(17)-1(c)	An acquiring corporation files a Form 976, *Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust*, within 120 days after the date of the determination under section 547(c) to claim a deduction of a deficiency dividend.
10.	Treas. Reg. § 1.441-3(b)	A personal service corporation may obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period by filing From 1128, *Application to Adopt, Change, or Retain a Tax Year*, within such time as is provided in the administrative procedures published by the Commissioner. *See* Rev. Procs. 2002-38, 2002-1 C.B. 1037, and 2002-39.
11.	Sec. 562(b)(1)(B)	In the case of a complete liquidation (except in the case of a complete liquidation of a personal holding company or foreign personal holding company) occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to such plan shall, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend for purposes of computing the dividends paid deduction.
12.	Sec. 562(b)(2)	In the case of a complete liquidation of a personal holding company occurring within 24 months after the adoption of a plan of liquidation, the amount of any distribution within such period pursuant to such plan shall be treated as a dividend for purposes of computing the dividends paid deduction to the extent that such is distributed to corporate distributees and represents such corporate distributees' allocable share of the undistributed personal holding company income for the taxable year of such distribution.
13.	Sec. 597 and Treas. Reg. § 1.597-4(g)	A consolidated group of which an Institution (as defined by section 1.591-1(b)) is a subsidiary may elect irrevocably not to include the Institution in its affiliated group if the Institution is placed in Agency (as defined by section 1.591-1(b)) receivership (whether or not assets or deposit liabilities of the Institution are transferred to a Bridge Bank (as defined by section 1.591-1(b)). Except as otherwise provided in section 1.597-4(g)(6), a consolidated group makes the election by sending a written statement by certified mail to the affected Institution on or before the later of 120 days after its placement in Agency (as defined by section 1.591-1(b)) receivership or May 31, 1996.
14.	Sec. 1502 and Treas. Reg. § 1.1502-75(c)(1)(i)	A common parent must apply for permission to discontinue filing consolidated returns within a specified period after the date of enactment of a law affecting the computation of tax liability.
15.	Sec. 6425 and Treas. Reg. § 1.6425-1	Corporations applying for an adjustment of an overpayment of estimated income tax must file Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax*, on or before the 15th day of the third month after the taxable year, or before the date the corporation first files its income tax return for such year, whichever is earlier.
16.	Rev. Proc. 2003-33, Section 5	If the filer complies with the procedures set forth in the revenue procedure, including a requirement that the filer file Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases*, within the specified period, the filer gets an automatic extension under section 301.9100-3 to file an election under section 338.

SECTION 8. EMPLOYEE BENEFIT ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 72(p)(2)(B) and (C), and Treas. Reg. § 1.72(p)-1, Q&A-10	A loan from a qualified employer plan to a participant in, or a beneficiary of, such plan must be repaid according to certain time schedules specified in section 72(p)(2)(B) and (C) (including, if applicable, any grace period granted pursuant to section 1.72(p)-1, Q&A-10).
2.	Sec. 72(t)(2)(A)(iv)	Under section 72(t)(2)(A)(iv), to avoid the imposition of a 10-percent additional tax on a distribution from a qualified retirement plan, the distribution must be part of a series of substantially equal periodic payments, made at least annually.
3.	Sec. 72(t)(2)(F)	To avoid the imposition of a 10-percent additional tax on a distribution from an individual retirement arrangement (IRA) for a first-time home purchase, such distribution must be used within 120 days of the distribution to pay qualified acquisition costs or rolled into an IRA.
4.	Sec. 83(b) and Treas.	If substantially nonvested property to which section 83 applies is transferred to any person, the service provider may elect to

	Statute or Regulation	Act Postponed
	Reg. § 1.83-2(b)	include the excess of the fair market value of the property over the amount paid (if any) for the property in gross income for the taxable year in which such property is transferred. This election must occur not later than 30 days after the date the property was transferred.
5.	Proposed Treas. Reg. § 1.125-1, Q&A-15	Cafeteria plan participants will avoid constructive receipt of the taxable amounts if they elect the benefits they will receive before the beginning of the period during which the benefits will be provided.
6.	Proposed Treas. Reg. § 1.125-1, Q&A-14 and Proposed Treas. Reg. § 1.125-2, Q&A-7	Cafeteria plan participants will not be in constructive receipt if, at the end of the plan year, they forfeit amounts elected but not used during the plan year.
7.	Proposed Treas. Reg. § 1.125-2, Q&A-5	Cafeteria plan participants may receive in cash the value of unused vacation days on or before the earlier of the last day of the cafeteria plan year or the last day of the employee's taxable year to which the unused days relate.
8.	Treas. Reg. § 1.162-27(e)(2)	A performance goal is considered preestablished if it is established in writing by the corporation's compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates if the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. In no event, however, will the performance goal be considered pre-established if it is established after 25 percent of the period of service has elapsed.
9.	Sec. 220(f)(5)	A rollover contribution to an Archer MSA must be made no later than the 60th day after the day on which the holder receives a payment or distribution from an Archer MSA.
10.	Sec. 220(h)	A trustee or custodian of an MSA (Archer MSA or Medicare+Choice MSA) must provide certain information concerning the MSA to the account holder by January 31 following the calendar year to which the information relates. In addition, MSA contribution information must be furnished to the account holder, and Form 5498 filed with the IRS, by May 31 following the calendar year to which the information relates.
11.	Secs. 401(a)(9), 403(a)(1), 403(b)(10), 408(a)(6), 408(b)(3) and 457(d)(2)	The first required minimum distribution from plans subject to the rules in section 401(a)(9) must be made no later than the required beginning date. Subsequent required minimum distributions must be made by the end of each distribution calendar year.
12.	Sec. 401(a)(28)(B)(i)	A qualified participant in an ESOP (as defined in section 401(a)(28)(B)(iii)) may elect within 90 days after the close of each plan year in the qualified election period (as defined in section 401(a)(28)(B)(iv)) to direct the plan as to the investment of at least 25 percent of the participant's account in the plan (50 percent in the case of the last election).
13.	Sec. 401(a)(28)(B)(ii)	A plan must distribute the portion of the participant's account covered by an election under section 401(a)(28)(B)(i) within 90 days after the period during which an election can be made; or the plan must offer at least 3 investment options (not inconsistent with regulations prescribed by the Secretary) to each participant making the election under section 401(a)(28)(B)(i) and within 90 days after the period during which the election may be made, the plan must invest the portion of the participant's account in accordance with the participant's election.
14.	Sec. 401(a)(30) and Treas. Reg. § 1.401(a)-30 and § 1.402(g)-1	Excess deferrals for a calendar year, plus income attributable to the excess, must be distributed no later than the first April 15 following the calendar year.
15.	Sec. 401(b) and Treas. Reg. § 1.401(b)-1	A retirement plan that fails to satisfy the requirements of section 401(a) or section 403(a) on any day because of a disqualifying provision will be treated as satisfying such requirements on such day if, prior to the expiration of the applicable remedial amendment period, all plan provisions necessary to satisfy the requirements of section 401(a) or 403(a) are in effect and have been made effective for the whole of such period.
16.	Sec. 401(k)(8)	A cash or deferred arrangement must distribute excess contributions for a plan year, plus income attributable to the excess, pursuant to the terms of the arrangement no later than the close of the following plan year.
17.	Sec. 401(m)(6)	A plan subject to section 401(m) must distribute excess aggregate contributions for a plan year, plus income attributable to the excess, pursuant to the terms of the plan no later than the close of the following plan year.
18.	Sec. 402(g)(2)(A) and Treas. Reg. § 1.402(g)-1	An individual with excess deferrals for a taxable year must notify a plan, not later than a specified date following the taxable year that excess deferrals have been contributed to that plan for the taxable year. A distribution of excess deferrals identified by the individual, plus income attributable to the excess, must be accomplished no later than the first April 15 following the taxable year of the excess.
19.	Sec. 404(k)(2)(A)(ii)	An ESOP receiving dividends on stock of the C corporation maintaining the plan must distribute the dividend in cash to participants or beneficiaries not later than 90 days after the close of the plan year in which the dividend was paid.
20.	Secs. 408(i) and 6047(c)	A trustee or issuer of an individual retirement arrangement (IRA) must provide certain information concerning the IRA to the IRA owner by January 31 following the calendar year to which the information relates. In addition, IRA contribution information must be furnished to the owner, and Form 5498 filed with the IRS, by May 31 following the calendar year to which the information relates.
21.	Sec. 409(h)(4)	An employer required to repurchase employer securities under section 409(h)(1)(B) must provide a put option for a period of at least 60 days following the date of distribution of employer securities to a participant, and if the put option is not exercised, for an additional 60-day period in the following plan year. A participant who receives a distribution of employer securities under section 409(h)(1)(B) must exercise the put option provided by that section within a period of at least 60 days following the date of distribution, or if the put option is not exercised within that period, for an additional 60-day

	Statute or Regulation	Act Postponed
		period in the following plan year.
22.	Sec. 409(h)(5)	An employer required to repurchase employer securities distributed as part of a total distribution must pay for the securities in substantially equal periodic payments (at least annually) over a period beginning not later than 30 days after the exercise of the put option and not exceeding 5 years.
23.	Sec. 409(h)(6)	An employer required to repurchase employer securities distributed as part of an installment distribution must pay for the securities not later than 30 days after the exercise of the put option under section 409(h)(4).
24.	Sec. 409(o)	An ESOP must commence the distribution of a participant's account balance, if the participant elects, not later than 1 year after the close of the plan year — i) in which the participant separates from service by reason of attaining normal retirement age under the plan, death or disability; or ii) which is the 5th plan year following the plan year in which the participant otherwise separates from service (except if the participant is reemployed before distribution is required to begin).
25.	Sec. 457(e)(16)(B)	An eligible rollover distribution from a section 457 eligible governmental plan may be rolled over to an eligible retirement plan no later than the 60th day following the day the distributee received the distributed property.
26.	Sec. 1042(a)(2)	A taxpayer must purchase qualified replacement property (defined in section 1042(c)(4)) within the replacement period, defined in section 1042(c)(3) as the period which begins 3 months before the date of the sale of qualified securities to an ESOP and ends 12 months after the date of such sale.
27.	Sec. 4972(c)(3)	Nondeductible plan contributions must be distributed prior to a certain date to avoid a 10 percent tax.
28.	Sec. 4979 and Treas. Reg. § 54.4979-1	A 10 percent tax on the amount of excess contributions and excess aggregate contributions under a plan for a plan year will be imposed unless the excess, plus income attributable to the excess is distributed (or, if forfeitable, forfeited) no later than $2^1/_2$-months after the close of the plan year. In the case of an employer maintaining a SARSEP, employees must be notified of the excess by the employer within the $2^1/_2$-month period to avoid the tax.
29.	Secs. 6033, 6039D, 6047, 6057, 6058, and 6059	Form 5500, *Annual Return/Report of Employee Benefit Plan*, and Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*, which are used to report annual information concerning employee benefit plans and fringe benefit plans, must be filed by a specified time.*General Advice*Affected filers are advised to follow the instructions accompanying the Form 5500 series (or other guidance published on the postponement) regarding how to file the forms when postponements are granted pursuant to section 7508 or section 7508A.*Combat Zone Postponements under Section 7508*Individual taxpayers who meet the requirements of section 7508 are entitled to a postponement of time to file the Form 5500 or Form 5500-EZ under section 7508. The postponement of the Form 5500 series filing due date under section 7508 will also be permitted by the Department of Labor and the Pension Benefit Guaranty Corporation (PBGC) for similarly situated individuals who are plan administrators.*Postponements for Presidentially Declared Disasters and Terroristic or Military Actions under Section 7508A*In the case of "affected taxpayers," as defined in section 301.7508A-1(d), the IRS may permit a postponement of the filing of the Form 5500 or Form 5500-EZ. Taxpayers who are unable to obtain on a timely basis information necessary for completing the forms from a bank, insurance company, or any other service provider because such service providers' operations are located in a covered disaster area will be treated as "affected taxpayers." Whatever postponement of the Form 5500 series filing due date is permitted by the IRS under section 7508A will also be permitted by the Department of Labor and PBGC for similarly situated plan administrators and direct filing entities.
30.	Rev. Proc. 2003-44, Sections 9.02(1) and (2)	The correction period for self-correction of operational failures is the last day of the second plan year following the plan year for which the failure occurred. The correction period for self-correction of operational failures for transferred assets does not end until the last day of the first plan year that begins after the corporate merger, acquisition, or other similar employer transaction.
31.	Rev. Proc. 2003-44, Section 12.07	If the submission involves a plan with transferred assets and no new incidents of the failures in the submission occurred after the end of the second plan year that begins after the corporate merger, acquisition, or other similar employer transaction, the plan sponsor may calculate the amount of plan assets and number of plan participants based on the Form 5500 information that would have been filed by the plan sponsor for the plan year that includes the employer transaction if the transferred assets were maintained as a separate plan.
32.	Rev. Proc. 2003-44, Section 14.03	If an examination involves a plan with transferred assets and the IRS determines that no new incidents of the failures that relate to the transferred assets occurred after the end of the second plan year that begins after the corporate merger, acquisition, or other similar employer transaction, the sanction under Audit CAP will not exceed the sanction that would apply if the transferred assets were maintained as a separate plan.

SECTION 9. ESTATE, GIFT AND TRUST ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 643(g)	The trustee may elect to treat certain payments of estimated tax as paid by the beneficiary. The election shall be made on or before the 65th day after the close of the taxable year of the trust.
2.	Sec. 645 and Treas. Reg. § 1.645-1(c)	An election to treat a qualified revocable trust as part of the decedent's estate must be made by filing Form 8855, *Election To Treat a Qualified Revocable Trust as Part of an Estate*, by the due date (including extensions) of the estate's Federal income tax return for the estate's first taxable year, if there is an executor, or by the due date (including extensions) of the trust's Federal income tax return for the trust's first taxable year (treating the trust as an estate), if there is no executor.
3.	Sec. 2011(c)	The executor of a decedent's estate must file a claim for a credit for state estate, inheritance, legacy or succession taxes by filing a claim within 4 years of filing Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. (Section 2011 does not apply to estates of decedents dying after December 31, 2004; *see* section 2058).

	Statute or Regulation	Act Postponed
4.	Sec. 2014(e)	The executor of a decedent's estate must file a claim for foreign death taxes within 4 years of filing Form 706.
5.	Sec. 2016 and Treas. Reg. § 20.2016-1	If an executor of a decedent's estate (or any other person) receives a refund of any state or foreign death taxes claimed as a credit on Form 706, the IRS must be notified within 30 days of receipt. (Section 2016 is amended effective for estates of decedents dying after December 31, 2004; *see* section 2058).
6.	Sec. 2031(c)	If an executor of a decedent's estate elects on Form 706 to exclude a portion of the value of land that is subject to a qualified conservation easement, agreements relating to development rights must be implemented within 2 years after the date of the decedent's death.
7.	Sec. 2032(d)	The executor of a decedent's estate may elect an alternate valuation on a late filed Form 706 if the Form 706 is not filed later than 1 year after the due date.
8.	Sec. 2032A(c)(7)	A qualified heir, with respect to specially valued property, is provided a two-year grace period immediately following the date of the decedent's death in which the failure by the qualified heir to begin using the property in a qualified use will not be considered a cessation of qualified use and therefore will not trigger additional estate tax.
9.	Sec. 2032A(d)(3)	The executor of a decedent's estate has 90 days after notification of incomplete information/signatures to provide the information/signatures to the IRS regarding an election on Form 706 with respect to specially valued property.
10.	Sec. 2046	A taxpayer may make a qualified disclaimer no later than 9 months after the date on which the transfer creating the interest is made, or the date the person attains age 21.
11.	Sec. 2053(d) and Treas. Reg. §§ 20.2053-9(c) and 10(c)	If the executor of a decedent's estate elects to take a deduction for state and foreign death tax imposed upon a transfer for charitable or other uses, the executor must file a written notification to that effect with the IRS before expiration of the period of limitations on assessments (generally 3 years). (Section 2053 is amended effective for estates of decedents dying after December 31, 2004, to apply only with respect to foreign death taxes).
12.	Sec. 2055(e)(3)	A party in interest must commence a judicial proceeding to change an interest into a qualified interest no later than the 90th day after the estate tax return (Form 706) is required to be filed or, if no return is required, the last date for filing the income tax return for the first taxable year of the trust.
13.	Sec. 2056(d)	A qualified domestic trust (QDOT) election must be made on Form 706, Schedule M, and the property must be transferred to the trust before the date on which the return is made. Any reformation to determine if a trust is a QDOT requires that the judicial proceeding be commenced on or before the due date for filing the return.
14.	Sec. 2056A(b)(2)	The trustee of a QDOT must file a claim for refund of excess tax no later than 1 year after the date of final determination of the decedent's estate tax liability.
15.	Sec. 2057(i)(3)(G)	A qualified heir, with respect to qualified family owned business, has a two-year grace period immediately following the date of the decedent's death in which the failure by the qualified heir to begin using the property in a qualified use will not be considered a cessation of qualified use and therefore will not trigger additional estate tax. (The section 2057 election is not available to estates of decedents dying after December 31, 2004).
16.	Sec. 2057(i)(3)(H)	The executor of a decedent's estate has 90 days after notification of incomplete information/signatures to provide the information/signatures to the IRS regarding an election on Form 706 with respect to specially valued property.
17.	Sec. 2058(d)	The executor of a decedent's estate may deduct estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia from the decedent's gross estate. With certain exceptions, the deduction is only allowed provided the taxes are actually paid and the deduction claimed within 4 years of filing Form 706.
18.	Sec. 2516	The IRS will treat certain transfers as made for full and adequate consideration in money or money's worth where husband and wife enter into a written agreement relative to their marital and property rights and divorce actually occurs within the 3-year period beginning on the date 1 year before such agreement is entered into.
19.	Sec. 2518(b)	A taxpayer may make a qualified disclaimer no later than 9 months after the date on which the transfer creating the interest is made, or the date the person attains age 21.

SECTION 10. EXEMPT ORGANIZATION ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 501(h)	Under section 501(h), certain eligible 501(c)(3) organizations may elect on Form 5768, *Election/Revocation of Election by an Eligible Sec. 501(c)(3) Organization to Make Expenditures to Influence Legislation*, to have their legislative activities measured solely by expenditures. Form 5768 is effective beginning with a taxable period, provided it is filed before the end of the organization's taxable period.
2.	Sec. 505(c)(1)	An organization must give notice by filing Form 1024, *Application for Recognition of Exemption Under Section 501(a) or for Determination Under Section 120*, to be recognized as an organization exempt under section 501(c)(9) or section 501(c)(17). Generally, if the exemption is to apply for any period before the giving of the notice, section 505(c)-1T, Q&A-6, of the regulations requires that Form 1024 be filed within 15 months from the end of the month in which the organization was organized.
3.	Sec. 508 and Treas. Reg. § 1.508-1	A purported section 501(c)(3) organization must generally file Form 1023, *Application for Recognition of Exemption*, to qualify for exemption. Generally, if the exemption is to apply for any period before the giving of the notice, the Form 1023 must be filed within 15 months from the end of the month in which the organization was organized.
4.	Sec. 527(i)(2)	Certain political organizations shall not be treated as tax-exempt section 527 organizations unless each such organization electronically files a notice (Form 8871, *Political Organization Notice of Section 527 Status)* not less than 24 hours after the date on which the organization is established, or, in the case of a material change in the information required, not later than 30 days after

	Statute or Regulation	Act Postponed
		such material change.
5.	Sec. 527(j)(2)	Under section 527(j)(2), certain tax-exempt political organizations that accept contributions or make expenditures for an exempt function under section 527 during a calendar year are required to file periodic reports on Form 8872, *Political Organization Report of Contributions and Expenditures*, beginning with the first month or quarter in which they accept contributions or make expenditures, unless excepted. In addition, tax-exempt political organizations that make contributions or expenditures with respect to an election for federal office may be required to file pre-election reports for that election. A tax-exempt political organization that does not file the required Form 8872, or that fails to include the required information, must pay an amount calculated by multiplying the amount of the contributions or expenditures that are not disclosed by the highest corporate tax rate.
6.	Sec. 6033(g)(1) and Treas. Reg. § 1.6033-2(e)	Annual information returns, Forms 990, *Return of Organization Exempt From Income Tax*, of certain tax-exempt political organizations described under section 527 must be filed on or before the 15th day of the 5th month following the close of the taxable year.
7.	Sec. 6072(e) and Treas. Reg. § 1. 6033-2(e)	Annual returns of organizations exempt under section 501(a) must be filed on or before the 15th day of the 5th month following the close of the taxable year.
8.	Rev. Proc. 80-27, Section 6.01	The central organization of a group ruling is required to report information regarding the status of members of the group annually (at least 90 days before the close of its annual accounting period).

SECTION 11. EXCISE TAX ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 48.4101-1(h)(v)	A registrant must notify the IRS of any change in the information a registrant has submitted within 10 days.
2.	Sec. 4221(b) and Treas. Reg. § 48.4221-2(c)	A manufacturer is allowed to make a tax-free sale of articles for resale to a second purchaser for use in further manufacture. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.
3.	Sec. 4221(b) and Treas. Reg. § 48.4221-3(c)	A manufacturer is allowed to make a tax-free sale of articles for export. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.
4.	Sec. 4221(e)(2)(A) and Treas. Reg. § 48.4221-7(c)	A manufacturer is allowed to make a tax-free sale of tires for use by the purchaser in connection with the sale of another article manufactured or produced by the purchaser. This rule ceases to apply six months after the earlier of the sale or shipment date unless the manufacturer receives certain proof.

SECTION 12. INTERNATIONAL ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 482 and Treas. Reg. § 1.482-1(g)(4)(ii)(C)	A claim for a setoff of a section 482 allocation by the IRS must be filed within 30 days of either the date of the IRS's letter transmitting an examination report with notice of the proposed adjustment or the date of a notice of deficiency.
2.	Sec. 482 and Treas. Reg. § 1.482-1(j)(2)	A claim for retroactive application of the final section 482 regulations, otherwise effective only for taxable years beginning after October 6, 1994, must be filed prior to the expiration of the statute of limitations for the year for which retroactive application is sought.
3.	Sec. 482 and Treas. Reg. § 1.482-7(j)(2)	A participant in a cost-sharing arrangement must provide documentation regarding the arrangement, as well as documentation specified in sections 1.482-7(b)(4) and 1.482-7(c)(1), within 30 days of a request by the IRS.
4.	Treas. Reg. § 1.882-5(d)(2)(ii)(A)(2)	Liabilities of a foreign corporation that is not a bank must be entered on a set of books at a time reasonably contemporaneous with the time the liabilities are incurred.
5.	Treas. Reg. § 1.882-5(d)(2)(iii)(A)(1)	Liabilities of foreign corporations that are engaged in a banking business must be entered on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred.
6.	Treas. Reg. § 1.884-2T(b)(3)(i)	Requirement that marketable securities be identified on the books of a U.S. trade or business within 30 days of the date an equivalent amount of U.S. assets ceases to be U.S. assets. This requirement applies when a taxpayer has elected to be treated as remaining engaged in a U.S. trade or business for branch profits tax purposes.
7.	Treas. Reg. § 1.884-4(b)(3)(ii)(B)	Requirement that a foreign corporation which identifies liabilities as giving rise to U.S. branch interest, send a statement to the recipients of such interest within two months of the end of the calendar year in which the interest was paid, stating that such interest was U.S. source income (if the corporation did not make a return pursuant to section 6049 with respect to the interest payment).
8.	Sec. 922(a)(1)(E) and Treas. Reg. § 1.922-1(j)(Q&A-19)	The FSC must appoint a new non-U.S. resident director within 30 days of the date of death, resignation, or removal of the former director, in the event that the sole non-U.S. resident director of a FSC dies, resigns, or is removed.

	Statute or Regulation	Act Postponed
9.	Sec. 924(b)(2)(B) and Treas. Reg. § 1.924(a)-1T(j)(2)(i)	A taxpayer must execute an agreement regarding unequal apportionment at a time when at least 12 months remain in the period of limitations (including extensions) for assessment of tax with respect to each shareholder of the small FSC in order to apportion unequally among shareholders of a small FSC the $5 million foreign trading gross receipts used to determine exempt foreign trade income.
10.	Sec. 924(c)(2) and Treas. Reg. § 1.924(c)-1(c)(4)	The FSC must open a new qualifying foreign bank account within 30 days of the date of termination of the original bank account, if a FSC's qualifying foreign bank account terminates during the taxable year due to circumstances beyond the control of the FSC.
11.	Sec. 924(c)(3) and Treas. Reg. § 1.924(c)-1(d)(1)	The FSC must transfer funds from its foreign bank account to its U.S. bank account, equal to the dividends, salaries, or fees disbursed, and such transfer must take place within 12 months of the date of the original disbursement from the U.S. bank account, if dividends, salaries, or fees are disbursed from a FSC's U.S. bank account.
12.	Sec. 924(c)(3) and Treas. Reg. § 1.924(c)-1(d)(2)	The FSC must reimburse from its own bank account any dividends or other expenses that are paid by a related person, on or before the due date (including extensions) of the FSC's tax return for the taxable year to which the reimbursement relates.
13.	Sec. 924(c)(3) and Treas. Reg. § 1.924(c)-1(d)(3)	If the Commissioner determines that the taxpayer acted in good faith, the taxpayer may comply with the reimbursement requirement by reimbursing the funds within 90 days of the date of the Commissioner's determination, notwithstanding a taxpayer's failure to meet the return-filing-date reimbursement deadline in section 1.924(c)-1(d)(2).
14.	Sec. 924(e)(4) and Treas. Reg. § 1.924(e)-1(d)(2)(iii)	If a payment with respect to a transaction is made directly to the FSC or the related supplier in the United States, the funds must be transferred to and received by the FSC bank account outside the United States no later than 35 days after the receipt of good funds (*i.e.*, date of check clearance) on the transaction.
15.	Temp. Treas. Reg. § 1.925(a)-1T(e)(4)	A FSC and its related supplier may redetermine a transfer pricing method, the amount of foreign trading gross receipts, and costs and expenses, provided such redetermination occurs before the expiration of the statute of limitations for claims for refund for both the FSC and related supplier, and provided the statute of limitations for assessment applicable to the party that has a deficiency in tax on account of the redetermination is open. *See* Treas. Reg. § 1.925(a)-1(c)(8)(i) for time limitations with respect to FSC administrative pricing grouping redeterminations and for a cross-reference to section 1.925(a)-1T(e)(4).
16.	Sec. 927(f)(3)(A) and Treas. Reg. § 1.927(f)-1(b) (Q&A-12)	A corporation may terminate its election to be treated as a FSC or a small FSC by revoking the election during the first 90 days of the FSC taxable year (other than the first year in which the election is effective) in which the revocation was to take effect.
17.	Sec. 927 and Temp. Treas. Reg. § 1.927(a)-1T (d)(2)(i)(B)	A taxpayer may satisfy the destination test with respect to property sold or leased by a seller or lessor if such property is delivered by the seller or lessor (or an agent of the seller or lessor) within the United States to a purchaser or lessee, if the property is ultimately delivered outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within one year after the sale or lease.
18.	Sec. 927 and Temp. Treas. Reg. § 1.927(b)-1T(e)(2)(i)	A taxpayer that claims FSC commission deductions must designate the sales, leases, or rentals subject to the FSC commission agreement no later than the due date (as extended) of the tax return of the FSC for the taxable year in which the transaction(s) occurred.
19.	Sec. 927 and Treas. Reg. § 1.927(f)-1(a) (Q&A 4)	A transferee or other recipient of shares in the corporation (other than a shareholder that previously consented to the election) must consent to be bound by the prior election within 90 days of the first day of the FSC's taxable year to preserve the status of a corporation that previously qualified as a FSC or as a small FSC.
20.	Sec. 936 and Treas. Reg. § 1.936-11	A taxpayer that elects retroactive application of the regulation regarding separate lines of business for taxable years beginning after December 31, 1995, must elect to do so prior to the expiration of the statute of limitations for the year in question.
21.	Treas. Reg. §§ 1.964-1(c)(3)(ii) and -1T(g)(2)	An election of, or an adoption of or change in a method of accounting of a CFC (controlled foreign corporation) requires the filing of a written statement jointly executed by the controlling U.S. shareholders of the CFC within 180 days after the close of the taxable year of the CFC.
22.	Sec. 982(c)(2)(A)	Any person to whom a formal document request is mailed shall have the right to bring a proceeding to quash such request not later than the 90th day after the day such request was mailed.
23.	Treas. Reg. § 1.988-1(a)(7)(ii)	An election to have section 1.988-1(a)(2)(iii) apply to regulated futures contracts and nonequity options must be made on or before the first day of the taxable year, or if later, on or before the first day during such taxable year on which the taxpayer holds a contract described in section 988(c)(1)(D)(ii) and section 1.988-1(a)(7)(ii). A late election may be made within 30 days after the time prescribed for the election.
24.	Sec. 988(c)(1)(E)(iii)(V) (qualified fund) and Treas. Reg. § 1.988-1(a)(8)(i)(E)	A qualified fund election must be made on or before the first day of the taxable year, or if later, on or before the first day during such taxable year on which the partnership holds an instrument described in section 988(c)(1)(E)(i).
25.	Treas. Reg. § 1.988-3(b)	An election to treat (under certain circumstances) any gain or loss recognized on a contract described in section 1.988-2(d)(1) as capital gain or loss must be made by clearly identifying such transaction on taxpayer's books and records on the date the transaction is entered into.
26.	Treas. Reg. § 1.988-5(a)(8)(i)	Taxpayer must establish a record, and before the close of the date the hedge is entered into, the taxpayer must enter into the record for each qualified hedging transaction the information contained in sections 1.988-5(a)(8)(i)(A) through (E).
27.	Treas. Reg. § 1.988-5(b)(3)(i)	Taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge.

	Statute or Regulation	Act Postponed
28.	Treas. Reg. § 1.988-5(c)(2)	Taxpayer must identify a hedge and underlying stock or security under the rules of section 1.988-5(b)(3).
29.	Sec. 991	A corporation that elects IC-DISC treatment (other than in the corporation's first taxable year) must file Form 4876-A, *Election To Be Treated as an Interest Charge DISC*, with the regional service center during the 90-day period prior to the beginning of the tax year in which the election is to take effect.
30.	Sec. 991 and Treas. Reg. § 1.991-2(g)(2)	A corporation that filed a tax return as a DISC, but subsequently determines that it does not wish to be treated as a DISC, must notify the Commissioner more than 30 days before the expiration of period of limitations on assessment applicable to the tax year.
31.	Sec. 992 and Treas. Reg. § 1.992-2(a)(1)(i)	A qualifying corporation must file Form 4876-A or attachments thereto, containing the consent of every shareholder of the corporation to be treated as a DISC as of the beginning of the corporation's first taxable year.
32.	Sec. 992 and Treas. Reg. § 1.992-2(b)(2)	A qualifying corporation must file consents of the shareholders of the corporation to be treated as a DISC with the service center with which the DISC election was first filed, within 90 days after the first day of the taxable year, or within the time granted for an extension to file such consents.
33.	Sec. 992 and Treas. Reg. § 1.992-2(e)(2)	A corporation seeking to revoke a prior election to be treated as a DISC, must file a statement within the first 90 days of the taxable year in which the revocation is to take effect with the service center with which it filed the election or, if the corporation filed an annual information return, by filing the statement at the service center with which it filed its most recent annual information return.
34.	Sec. 992 and Treas. Reg. § 1.992-3(c)(3)	A DISC that makes a deficiency distribution with respect to the 95 percent of gross receipts test or the 95 percent assets test, or both tests, for a particular taxable year, must make such distribution within 90 days of the date of the first written notification from the IRS that the DISC failed to satisfy such test(s).
35.	Sec. 993 and Treas. Reg. § 1.993-3(d)(2)(i)(*b*)	In certain cases, property may not qualify as export property for DISC purposes unless, among other things, such property is ultimately delivered, directly used, or directly consumed outside the U.S. within one year of the date of sale or lease of the property.
36.	Sec. 1445 Treas. Reg. § 1.1445-1	Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, must be filed by a buyer or other transferee of a U.S. real property interest, and a corporation, partnership, or fiduciary that is required to withhold tax. The amount withheld is to be transmitted with Form 8288, which is generally to be filed by the 20th day after the date of transfer.
37.	Sec. 1446	All partnerships with effectively connected gross income allocable to a foreign partner in any tax year must file forms 8804, *Annual Return for Partnership Withholding Tax*, and 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*, on or before the 15th day of the 4th month following the close of the partnership's taxable year.
38.	Sec. 1446	Form 8813, *Partnership Withholding Tax Payment Voucher*, is used to pay the withholding tax under section 1446 for all partnerships with effectively connected gross income allocable to a foreign partner in any tax year. Form 8813, *Partnership Withholding Tax Payment Voucher (Section 1446)*, must accompany each payment of section 1446 tax made during the partnership's taxable year. Form 8813 is to be filed on or before the 15th day of the 4th, 6th, 9th, and 12th months of the partnership's taxable year for U.S. income tax purposes.
39.	Sec. 6038A(d)(2) and Treas. Reg. § 1.6038A-4(d)(1)	A reporting corporation must cure any failure to furnish information or failure to maintain records within 90 days after the IRS gives notice of the failure to avoid the continuation penalty.
40.	Sec. 6038A(d)(2) and Treas. Reg. § 1.6038A-4(d)(1)	A reporting corporation must cure any failure to furnish information or failure to maintain records before the beginning of each 30-day period after expiration of the initial 90-day period to avoid additional continuation penalties.
41.	Sec. 6038A(e)(1) and Treas. Reg. § 1.6038A-5(b)	A reporting corporation must furnish an authorization of agent within 30 days of a request by the IRS to avoid a penalty.
42.	Sec. 6038A(e)(4)(A)	A reporting corporation must commence any proceeding to quash a summons filed by the IRS in connection with an information request within 90 days of the date the summons is issued.
43.	Sec. 6038A(e)(4)(B)	A reporting corporation must commence any proceeding to review the IRS's determination of noncompliance with a summons within 90 days of the IRS's notice of noncompliance.
44.	Sec. 6038A and Treas. Reg. § 1.6038A-3(b)(3)	A reporting corporation must supply an English translation of records provided pursuant to a request for production within 30 days of a request by the IRS for a translation to avoid a penalty.
45.	Sec. 6038A and Treas. Reg. § 1.6038A-3(f)(2)	A reporting corporation must, within 60 days of a request by the IRS for records maintained outside the United States, either provide the records to the IRS, or move them to the United States and provide the IRS with an index to the records to avoid a penalty.
46.	Sec. 6038A and Treas. Reg. § 1.6038A-3(f)(2)(i)	A reporting corporation must supply English translations of documents maintained outside the United States within 30 days of a request by the IRS for translation to avoid a penalty.
47.	Sec. 6038A and Treas. Reg. § 1.6038A-3(f)(4)	A reporting corporation must request an extension of time to produce or translate documents maintained outside the United States beyond the period specified in the regulations within 30 days of a request by the IRS to avoid a penalty.
48.	Secs. 6038, 6038B, and 6046A	The filing of Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, for those taxpayers who do not have to file an income tax return. The form is due at the time that an income tax return would have been due had the taxpayer been required to file an income tax return.

	Statute or Regulation	Act Postponed
49.	Sec. 6662(e) and Treas. Reg. § 1.6662-6(d)(2)(iii)(A)	A taxpayer must provide, within 30 days of a request by the IRS, specified "principal documents" regarding the taxpayer's selection and application of transfer pricing method to avoid potential penalties in the event of a final transfer pricing adjustment by the IRS. *See also* Treas. Reg. § 1.6662-6(d)(2)(iii)(C) (similar requirement re: background documents).

SECTION 13. PARTNERSHIP AND S CORPORATION ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. §§ 1.442-1(b)(1) and (3) and 1.706-1(b)(8)	A partnership may obtain approval of the Commissioner to adopt, change or retain an annual accounting period by filing Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, with such time as provided in administrative procedures published by the Commissioner.
2.	Treas. Reg. § 1.743-1(k)(2)	A transferee that acquires, by sale or exchange, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange. A transferee that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner.
3.	Treas. Reg. § 1.754-1(c)(1)	Generally, a partnership may revoke a section 754 election by filing the revocation no later than 30 days after the close of the partnership taxable year with respect to which the revocation is intended to take effect.
4.	Treas. Reg. § 1.761-2(b)(3)	A partnership may generally elect to be excluded from subchapter K. The election will be effective unless within 90 days after the formation of the organization any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization and also advises the Commissioner that he has so notified all other members of the organization. In addition, an application to revoke an election to be excluded from subchapter K must be submitted no later than 30 days after the beginning of the first taxable year to which the revocation is to apply.
5.	Treas. Reg. § 1.761-2(c)	A partnership requesting permission to be excluded from certain provisions of subchapter K must submit the request to the Commissioner no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired.
6.	Sec. 1361(e)	In general, the trustee of the electing small business trust (ESBT) must file the ESBT election within the 2-month and 16-day period beginning on the day the stock is transferred to the trust. *See* Treas. Reg. § 1.1361-1(m)(2)(ii).
7.	Treas. Reg. § 1.1361-1(j)(6)	The current income beneficiary of a qualified subchapter S trust (QSST) must make a QSST election within the 2-month and 16-day period from one of the dates prescribed in section 1.1361-1(j)(6)(iii).
8.	Treas. Reg. § 1.1361-1(j)(10)	The successive income beneficiary of a QSST may affirmatively refuse to consent to the QSST election. The beneficiary must sign the statement and file the statement with the IRS within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary.
9.	Treas. Reg. § 1.1361-3(a)(4)	If an S corporation elects to treat an eligible subsidiary as a qualified subchapter S subsidiary (QSUB), the election cannot be effective more than 2 months and 15 days prior to the date of filing the election.
10.	Treas. Reg. § 1.1361-3(b)(2)	An S corporation may revoke a QSUB election by filing a statement with the service center. The effective date of a revocation of a QSUB election cannot be more than 2 months and 15 days prior to the filing date of the revocation.
11.	Treas. Reg. § 1.1362-2(a)(2), (4)	If a corporation revokes its subchapter S election after the first $2^1/_2$-months of its taxable year, the revocation will not be effective until the following taxable year. An S corporation may rescind a revocation of an S election at any time before the revocation becomes effective.
12.	Sec. 1362(b)(1)	An election under section 1362(a) to be an S corporation may be made by a small business corporation for any taxable year at any time during the preceding taxable year, or at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year.
13.	Rev. Proc. 2003-43	This revenue procedure provides a simplified method for taxpayers requesting relief for late S corporation elections, Qualified Subchapter S Subsidiary (QSUB) elections, Qualified Subchapter S Trust (QSST) elections, and Electing Small Business Trust (ESBT) elections. Generally, this revenue procedure provides that certain eligible entities may file late elections within 24 months of the due date of the election.
14.	Rev. Proc. 2004-48	This revenue procedure provides a simplified method for taxpayers to request relief for a late S corporation election and a late corporate classification election which was intended to be effective on the same date that the S corporation election was intended to be effective. This revenue procedure provides that within 6 months after the due date for the tax return, excluding extensions, for the first year the entity intended to be an S corporation, the corporation must file a properly completed Form 2553, *Election by a Small Business Corporation*, with the applicable service center.
15.	Sec. 1378(b) and Treas. Reg. § 1.1378-1(c)	An S or electing S corporation may obtain the approval of the Commissioner to adopt, change or retain an annual accounting period by filing Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, within such time as is provided in administrative procedures published by the Commissioner. *See* Rev. Procs. 2002-38 and 2002-39.

SECTION 14. PROCEDURE & ADMINISTRATION ISSUES

.01 Bankruptcy and Collection

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 301.6036-1(a)(2) and (3)	A court-appointed receiver or fiduciary in a non-bankruptcy receivership, a fiduciary in aid of foreclosure who takes possession of substantially all of the debtor's assets, or an assignee for benefit of creditors, must give written notice within ten days of his appointment to the IRS as to where the debtor will file his tax return.
2.	Sec. 6320(a)(3)(B) and (c) and Treas. Reg. § 301.6320-1(b), (c) and (f)	A taxpayer has 30 days after receiving a notice of a lien to request a Collection Due Process (CDP) administrative hearing. After a determination at the CDP hearing, the taxpayer may appeal this determination within 30 days to the United States Tax Court or a United States district court.
3.	Sec. 6330(a)(3)(B) and (d)(1) and Treas. Reg. § 301.6330-1(b), (c) and (f)	The taxpayer must request a Collections Due Process (CDP) administrative hearing within 30 days after the IRS sends notice of a proposed levy. After a determination at the CDP hearing, the taxpayer may appeal this determination within 30 days to the United States Tax Court or a United States district court.
4.	Sec. 6331(k)(1) and Treas. Reg. § 301.7122-1(g)(2)	If a taxpayer submits a good-faith revision of a rejected offer in compromise within 30 days after the rejection, the Service will not levy to collect the liability before deciding whether to accept the revised offer.
5.	Sec. 6331(k)(2) and Treas. Reg. § 301.6331-4(a)(1)	If, within 30 days following the rejection or termination of an installment agreement, the taxpayer files an appeal with the IRS Office of Appeals, no levy may be made while the rejection or termination is being considered by Appeals.
6.	Sec. 7122(d)(2) and Treas. Reg. § 301.7122-1(f)(5)(i)	A taxpayer must request administrative review of a rejected offer in compromise within 30 days after the date on the letter of rejection.

.02 Information Returns

	Statute or Regulation	Act Postponed
1.	Sec. 6050I	Any person engaged in a trade or business receiving more than $10,000 cash in one transaction (or 2 or more related transactions) must file an information return, Form 8300, *Report of Cash Payments over $10,000 Received in a Trade or Business*, by the 15th day after the date the cash was received. Additionally, a statement must be provided to the person with respect to whom the information is required to be furnished by Jan. 31st of the year following.
2.	Sec. 6050L	Returns relating to certain dispositions of donated property, Forms 8282, *Donee Information Return*, must be filed within 125 days of the disposition.

.03 Miscellaneous

	Statute or Regulation	Act Postponed
1.	Sec. 1314(b)	A taxpayer may file a claim for refund or credit of tax based upon the mitigation provisions of sections 1311 through 1314 if, as of the date a determination (as defined in section 1313(a)) is made, one year remains on the period for filing a claim for refund.
2.	Sec. 6015	A requesting spouse must request relief under section 6015 within 2 years of the first collection activity against the requesting spouse.
3.	Sec. 6411	Taxpayers applying for a tentative carryback adjustment of the tax for the prior taxable year must file Form 1139, *Corporation Application for Tentative Refund,* (for corporations) or Form 1045, *Application for Tentative Refund,* (for entities other than corporations) within 12 months after the end of such taxable year that generates such net operating loss, net capital loss, or unused business credit from which the carryback results.
4.	Sec. 6656(e)(2)	A taxpayer who is required to deposit taxes and fails to do so is subject to a penalty under section 6656. Under section 6656(e)(2), the taxpayer may, within 90 days of the date of the penalty notice, designate to which deposit period within a specified tax period the deposits should be applied.

SECTION 15. TAX CREDIT ISSUES

	Statute or Regulation	Act Postponed
1.	Sec. 42(e)(3)(A)(ii)	A taxpayer has a 24-month measuring period in which the requisite amount of rehabilitation expenditures has to be incurred in order to qualify for treatment as a separate new building.
2.	Treas. Reg. § 1.42-5(c)(1)	The taxpayer must make certain certifications at least annually to the Agency.
3.	Treas. Reg. § 1.42-5(c)(1)(iii)	The taxpayer must receive an annual income certification from each low-income tenant with documentation to support the certification.
4.	Treas. Reg. § 1.42-8(a)(3)(v)	The taxpayer and an Agency may elect to use an appropriate percentage under section 42(b)(2)(A)(ii)(I) by notarizing a binding agreement by the 5th day following the end of the month in which the binding agreement was made.
5.	Treas. Reg. § 1.42-8(b) (1)(vii)	The taxpayer and an Agency may elect an appropriate percentage under section 42(b)(2)(A)(ii)(II) by notarizing a binding agreement by the 5th day following the end of the month in which the tax-exempt bonds are issued.

	Statute or Regulation	Act Postponed
6.	Sec. 42(d)(2)(D)(ii)(IV)	In order to claim section 42 credits on an existing building, section 42(d)(2)(B)(ii)(I) requires that the building must have been placed in service at least ten years before the date the building was acquired by the taxpayer. A building is not considered placed in service for purposes of section 42(d)(2)(B)(ii) if the building is resold within a 12-month period after acquisition by foreclosure of any purchase-money security interest.
7.	Sec. 42(g)(3)(A)	A building shall be treated as a qualified low-income building only if the project meets the minimum set aside requirement by the close of the first year of the credit period of the building.
8.	Sec. 42(h)(6)(J)	A low-income housing agreement commitment must be in effect as of the beginning of the year for a building to receive credit. If such a commitment was not in effect, the taxpayer has a one-year period for correcting the failure.
9.	Sec. 42(h)(1)(E) and (F)	The taxpayer's basis in the building project, as of the later of the date which is 6 months after the date the allocation was made or the close of the calendar year in which the allocation is made, must be more than 10 percent of the taxpayer's reasonably expected basis in the project.
10.	Sec. 47(c)(1)(C) and Treas. Reg. § 1.48-12(b)(2)	A taxpayer has a 24- or 60-month measuring period in which the requisite amount of rehabilitation expenditures have to be incurred in order to satisfy the "substantial rehabilitation" test.
11.	Treas. Reg. § 1.48-12(d)(7)	In the historic rehabilitation context, if the taxpayer fails to receive final certification of completed work prior to the date that is 30 months after the date that the taxpayer filed the return on which the credit is claimed, the taxpayer must, prior to the last day of the 30th month, consent to extending the statute of limitations by submitting a written statement to the Service.
12.	Sec. 51(d)(12)(A)(ii)(II) and 51A(d)(1)	An employer seeking the Work Opportunity Credit or the Welfare-to-Work Credit with respect to an individual must submit Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits*, to the State Employment Security Agency not later than the 21st day after the individual begins work for the employer.

SECTION 16. TAX-EXEMPT BOND ISSUES

	Statute or Regulation	Act Postponed
1.	Treas. Reg. § 1.25-4T(c)	On or before the date of distribution of mortgage credit certificates under a program or December 31, 1987, the issuer must file an election not to issue an amount of qualified mortgage bonds. An election may be revoked, in whole or on part, at any time during the calendar year in which the election was made.
2.	Treas. Reg. §§ 1.141-12(d)(3) and 1.142-2(c)(2)	An issuer must provide notice to the Commissioner of the establishment of a defeasance escrow within 90 days of the date such defeasance escrow is established in accordance with sections 1.141-12(d)(1) or 1.142-2(c)(1).
3.	Sec. 142(d)(7)	An operator of a multi-family housing project for which an election was made under section 142(d) must submit to the Secretary an annual certification as to whether such project continues to meet the requirements of section 142(d).
4.	Sec. 142(f)(4) and Treas. Reg. § 1.142(f)(4)-1	A person engaged in the local furnishing of electric energy or gas (a local furnisher) that uses facilities financed with exempt facility bonds under section 142(a)(8) and expands its service area in a manner inconsistent with the requirements of sections 142(a)(8) and 142(f), may make an election to ensure that those bonds will continue to be treated as exempt facility bonds. The election must be filed with the IRS on or before 90 days after the date of the service area expansion that causes the bonds to cease to meet the applicable requirements.
5.	Sec. 146(f) and Notice 89-12	If an issuing authority's volume cap for any calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during such calendar year by such authority, such authority may elect to treat all (or any portion) of such excess as a carryforward for 1 or more carryforward purposes. Such election must be filed by the earlier of (1) February 15 of the calendar year following the year in which the excess amount arises, or (2) the date of issue of bonds issued pursuant to the carryforward election.
6.	Sec. 148(f)(3) and Treas. Reg. § 1.148-3(g)	An issuer of a tax-exempt municipal obligation must make any required rebate payment no later than 60 days after the computation date to which the payment relates. A rebate payment is paid when it is filed with the IRS at the place or places designated by the Commissioner. A payment must be accompanied by the form provided by the Commissioner for this purpose.
7.	Treas. Reg. § 1.148-5(c)	An issuer of a tax-exempt municipal obligation must make a yield reduction payment on or before the date of required rebate installment payments as described in section 1.148-3(f), (g), and (h).
8.	Sec. 148(f)(4)(C)(xvi) and Treas. Reg. § 1.148-7(k)(1)	As issuer of a tax-exempt municipal obligation that elects to pay certain penalties in lieu of rebate must make any required penalty payments not later than 90 days after the period to which the penalty relates.
9.	Sec. 149(e)	An issuer of a tax-exempt municipal obligation must submit to the Secretary a statement providing certain information regarding the municipal obligation not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the municipal obligation is issued.

SECTION 17. SPECIAL RULES FOR SECTION 1031 LIKE-KIND EXCHANGE TRANSACTIONS

.01 (1) The last day of a 45-day identification period set forth in section 1.1031(k)-1(b)(2) of the Income Tax Regulations, the last day of a 180-day exchange period set forth in section 1.1031(k)-1(b)(2), and the last day of a period set forth in section 4.02(3) through (6) of Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, that falls on or after the date of a Presidentially declared disaster is postponed by 120 days or to the last day of the

general disaster extension period authorized by an IRS News Release or other guidance announcing tax relief for victims of the specific Presidentially declared disaster, whichever is later, if such IRS News Release or other guidance provides relief for acts listed in this revenue procedure.

(2) A taxpayer who is a transferor qualifies for a postponement under section 17.01 only if—

(a) The relinquished property was transferred on or before the date of the Presidentially declared disaster, or in a transaction governed by Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, qualified *indicia* of ownership were transferred to the exchange accommodation titleholder on or before that date; and

(b) The taxpayer (transferor)—

i. Is an "affected taxpayer" as defined in the IRS News Release or other guidance announcing tax relief for the victims of the specific Presidentially declared disaster; or

ii. Has difficulty meeting the 45-day identification or 180-day exchange deadline set forth in section 1.1031(k)-1(b)(2), or a deadline set forth in section 4.02(3) through (6) of Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, due to the Presidentially declared disaster for the following or similar reasons:

A. The relinquished property or the replacement property is located in a covered disaster area (as defined in section 301.7508A-1(d)(2)) as provided in the IRS News Release or other guidance (the covered disaster area);

B. The principal place of business of any party to the transaction (for example, a qualified intermediary, exchange accommodation titleholder, transferee, settlement attorney, lender, financial institution, or a title insurance company) is located in the covered disaster area;

C. Any party to the transaction (or an employee of such a party who is involved in the section 1031 transaction) is killed, injured, or missing as a result of the Presidentially declared disaster;

D. A document prepared in connection with the exchange (for example, the agreement between the transferor and the qualified intermediary or the deed to the relinquished property or replacement property) or a relevant land record is destroyed, damaged, or lost as a result of the Presidentially declared disaster;

E. A lender decides not to fund either permanently or temporarily a real estate closing due to the Presidentially declared disaster or refuses to fund a loan to the taxpayer because flood, disaster, or other hazard insurance is not available due to the Presidentially declared disaster; or

F. A title insurance company is not able to provide the required title insurance policy necessary to settle or close a real estate transaction due to the Presidentially declared disaster.

.02 The postponement described in section 17.01 also applies to the last day of a 45-day identification period described in section 1.1031(k)-1(b)(2) and the last day of a 45-day identification period described in section 4.05(4) of Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51, that falls prior to the date of a Presidentially declared disaster if an identified replacement property (in the case of an exchange described in section 1.1031(k)-1), or an identified relinquished property (in the case of an exchange described in Rev. Proc. 2000-37, modified by Rev. Proc. 2004-51) is substantially damaged by the Presidentially declared disaster.

.03 For purposes of this section 17, the deadlines to which the 120-day postponements apply do not include the due date of the taxpayer's tax return in section 1.1031(k)-1(b)(2), which is used to determine the last day of the exchange period.

.04 If the taxpayer (transferor) qualifies for relief under this section for any reason other than section 17.01(2)(b)(i), then such taxpayer is not considered an affected taxpayer for purposes of any other act listed in this revenue procedure or for any acts listed in an IRS News Release or other published guidance related to the specific Presidentially declared disaster.

SECTION 18. INQUIRIES

If you wish to recommend that other acts qualify for postponement, please write to the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division), CC:PA:APJP:B2, 1111 Constitution Avenue, NW, Washington, DC 20224. Please mark "7508A List" on the envelope. In the alternative, e-mail your comments to: *Notice.Comments@irscounsel.treas.gov*, and refer to Rev. Proc. 2005-27 in the Subject heading.

SECTION 19. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2004-13, 2004-4 I.R.B. 335, is superseded.

SECTION 20. EFFECTIVE DATE

This revenue procedure is effective for acts that may be performed on or after May 16, 2005.

SECTION 21. DRAFTING INFORMATION

The principal author of this revenue procedure is Dillon Taylor of the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). For further information regarding this revenue procedure, contact Mr. Taylor at (202) 622-4940 (not a toll-free call).

REVENUE PROCEDURE 2004-51

Internal Revenue Service (IRS)
Revenue Procedure (Rev. Proc.)
Released: July 20, 2004
Published: August 16, 2004

Like-Kind Exchanges Using Qualified Exchange Accommodation Arrangements

(Also Part I, Sections 1031; 1.1031(a)-1; 1.1031(k)-1.)

Like-kind exchanges using qualified exchange accommodation arrangements. This procedure modifies Rev. Proc. 2000-37, 2000-2 C.B. 308, to provide that the safe harbor of Rev. Proc. 2000-37 does not apply to replacement property held in a qualified exchange accommodation arrangement if the property is owned by a taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder. Rev. Proc. 2000-37 modified.

SECTION 1. PURPOSE

This revenue procedure modifies sections 1 and 4 of Rev. Proc. 2000-37, 2000-2 C.B. 308, to provide that Rev. Proc. 2000-37 does not apply if the taxpayer owns the property intended to qualify as replacement property before initiating a qualified exchange accommodation arrangement (QEAA).

SECTION 2. BACKGROUND

.01 Section 1031(a) 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 that is to be held either for productive use in a trade or business or for investment.

.02 Section 1031(a)(3) allows taxpayers to structure deferred like-kind exchanges. Under Section 1031(a)(3), property may be treated as like-kind property if it is (A) identified as property to be received in the exchange (replacement property) on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange (relinquished property), and (B) received before the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extensions) for the transferor's federal income tax return for the taxable year in which the transfer of the relinquished property occurs.

.03 Rev. Proc. 2000-37 addresses "parking" transactions. See sections 2.05 and 2.06 of Rev. Proc. 2000-37. Parking transactions typically are designed to "park" the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party transfers the relinquished property to the ultimate transferee. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange that property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of the property to the ultimate transferee. Rev. Proc. 2000-37 provides procedures for qualifying parking transactions as like-kind exchanges in situations in which the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that the taxpayer arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter.

.04 Section 4.01 of Rev. Proc. 2000-37 provides that the Internal Revenue Service will not challenge the qualification of property held in a QEAA "as either 'replacement property' or 'relinquished property' (as defined in Section 1.1031(k)-1(a)) for purposes of Section 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property...." Thus, taxpayers are not required to establish that the exchange accommodation titleholder bears the economic benefits and burdens of ownership and is the "owner" of the property. The Service and Treasury Department are aware that some taxpayers have interpreted this language to permit a taxpayer to treat as a like-kind exchange a transaction in which the taxpayer transfers property to an exchange accommodation titleholder and receives that same property as replacement property in a purported exchange for other property of the taxpayer.

.05 An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of Section 1031. See DeCleene v. Commissioner, 115 T.C. 457 (2000); Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d 14 (7th Cir. 1951). Moreover, Rev. Rul. 67-255, 1967-2 C.B. 270, holds that a building constructed on land owned by a taxpayer is not of a like kind to involuntarily converted land of the same taxpayer. Rev. Proc. 2000-37 does not abrogate the statutory requirement of Section 1031 that the transaction be an exchange of like-kind properties.

.06 The Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers applying the safe harbor rules set forth in Rev. Proc. 2000-37 in structuring like-kind exchanges.

SECTION 4. APPLICATION

.01 Section 1 of Rev. Proc. 2000-37 is modified to read as follows:

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

.02 Section 4.01 of Rev. Proc. 2000-37 is modified to read as follows:

SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS

.01 In general.

The Service will treat an exchange accommodation titleholder as the beneficial owner of property for federal income tax purposes if the property is held in a QEAA. Property held in a QEAA may, therefore, qualify as either "replacement property" or "relinquished property" (as defined in Section 1.1031(k)-1(a)) in a tax-deferred like-kind exchange if the exchange otherwise meets the requirements for deferral of gain or loss under Section 1031 and the regulations thereunder.

.03 Section 4.05 is added to Rev. Proc. 2000-37 to read as follows:

.05 Limitation.

This revenue procedure does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000-37 is modified.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for transfers on or after July 20, 2004, of qualified indicia of ownership to exchange accommodation titleholders (as described in section 4.02(1) of Rev. Proc. 2000-37).

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Baumgarten at (202) 622-4920 (not a toll-free call).

REVENUE PROCEDURE 2000-37

Internal Revenue Service (IRS)
Revenue Procedure (Rev. Proc.)
Released: September 19, 2000
Published: October 2, 2000

Like-Kind Exchanges; Replacement Property; "Parking" Arrangements

26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment; 1.1031(k)-1: Treatment of deferred exchanges.

Like-kind exchanges; replacement property; "parking" arrangements. This procedure provides a safe harbor under which the Service will not challenge (a) the qualification of property as either "replacement property" or "relinquished property" for purposes of section 1031 of the Code or (b) the treatment of the ""exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" (QEAA).

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either ""replacement property" or "relinquished property" (as defined in Section 1.1031(k)-1(a) of the Income Tax Regulations) for purposes of Section 1031 of the Internal Revenue Code and the regulations thereunder or (b) the treatment of the ""exchange accommodation titleholder" as the beneficial owner of such property for federal income tax purposes, if the property is held in a "qualified exchange accommodation arrangement" (QEAA), as defined in section 4.02 of this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 1031(a)(1) 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 that is to be held either for productive use in a trade or business or for investment.

.02 Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Determining the owner of property for federal income tax purposes requires an analysis of all of the facts and circumstances. As a general rule, the party that bears the economic burdens and benefits of ownership will be considered the owner of property for federal income tax purposes. See Rev. Rul. 82-144, 1982-2 C.B. 34.

.04 On April 25, 1991, the Treasury Department and the Service promulgated final regulations under Section 1.1031(k)-1 providing rules for deferred like-kind exchanges under Section 1031(a)(3). The preamble to the final regulations states that the deferred exchange rules under Section 1031(a)(3) do not apply to reverse-Starker exchanges (i.e., exchanges where the replacement property is acquired before the relinquished property is transferred) and consequently that the final regulations do not apply to such exchanges. T.D. 8346, 1991-1 C.B. 150, 151; see Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). However, the preamble indicates that Treasury and the Service will continue to study the applicability of the general rule of Section 1031(a)(1) to these transactions. T.D. 8346, 1991-1 C.B. 150, 151.

.05 Since the promulgation of the final regulations under Section 1.1031(k)- 1, taxpayers have engaged in a wide variety of transactions, including so-called "parking" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate transferee. In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes.

.06 Treasury and the Service have determined that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under Section 1031 in situations where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it arranges for the acquisition of the replacement property and actually accomplishes the exchange within a short time thereafter. Accordingly, this revenue procedure provides a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

SECTION 3. SCOPE

.01 Exclusivity. This revenue procedure provides a safe harbor for the qualification under Section 1031 of certain arrangements between taxpayers and exchange accommodation titleholders and provides for the treatment of the exchange accommodation titleholder as the beneficial owner of the

property for federal income tax purposes. These provisions apply only in the limited context described in this revenue procedure. The principles set forth in this revenue procedure have no application to any federal income tax determinations other than determinations that involve arrangements qualifying for the safe harbor.

.02 No inference. No inference is intended with respect to the federal income tax treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. Further, the Service recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in this revenue procedure. Accordingly, no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.

.03 Other issues. Services for the taxpayer in connection with a person's role as the exchange accommodation titleholder in a QEAA shall not be taken into account in determining whether that person or a related person is a disqualified person (as defined in Section 1.1031(k)-1(k)). Even though property will not fail to be treated as being held in a QEAA as a result of one or more arrangements described in section 4.03 of this revenue procedure, the Service still may recast an amount paid pursuant to such an arrangement as a fee paid to the exchange accommodation titleholder for acting as an exchange accommodation titleholder to the extent necessary to reflect the true economic substance of the arrangement. Other federal income tax issues implicated, but not addressed, in this revenue procedure include the treatment, for federal income tax purposes, of payments described in section 4.03(7) and whether an exchange accommodation titleholder may be precluded from claiming depreciation deductions (e.g., as a dealer) with respect to the relinquished property or the replacement property.

.04 Effect of Noncompliance. If the requirements of this revenue procedure are not satisfied (for example, the property subject to a QEAA is not transferred within the time period provided), then this revenue procedure does not apply. Accordingly, the determination of whether the taxpayer or the exchange accommodation titleholder is the owner of the property for federal income tax purposes, and the proper treatment of any transactions entered into by or between the parties, will be made without regard to the provisions of this revenue procedure.

SECTION 4. QUALIFIED EXCHANGE ACCOMMODATION ARRANGEMENTS

.01 Generally. The Service will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in Section 1.1031(k)-1(a)) for purposes of Section 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a QEAA.

.02 Qualified Exchange Accommodation Arrangements. For purposes of this revenue procedure, property is held in a QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in section 4.02(5) of this revenue procedure. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under Section 1031;

(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and this revenue procedure and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in this revenue procedure. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in Section 1.1031(k)-1(c). For purposes of this section, the taxpayer may properly identify alternative and multiple properties, as described in Section 1.1031(k)-1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in Section 1.1031(k)-1(g)(4))) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

.03 Permissible Agreements. Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in Section 1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under Section 1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;
(3) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;

(4) The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;

(5) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property;

(6) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; and

(7) The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

.04 Permissible Treatment. Property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between the taxpayer and the exchange accommodation titleholder is different from the treatment required by section 4.02(3) of this revenue procedure.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for QEAAs entered into with respect to an exchange accommodation titleholder that acquires qualified indicia of ownership of property on or after September 15, 2000.

SECTION 6. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1701. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information are contained in section 4.02 of this revenue procedure, which requires taxpayers and exchange accommodation titleholders to enter into a written agreement that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. This information is required to ensure that both parties to a QEAA treat the transaction consistently for federal tax purposes. The likely respondents are businesses and other for-profit institutions, and individuals.

The estimated average annual burden to prepare the agreement and certification is two hours. The estimated number of respondents is 1,600, and the estimated total annual reporting burden is 3,200 hours.

The estimated annual frequency of responses is on occasion.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Baumgarten at (202) 622-4950 (not a toll-free call).

PRIVATE LETTER RULING 200718028

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: May 4, 2007
February 5, 2007

Section 1031 -- Exchange of Property Held for Productive Use or Investment

Legend:

Taxpayer =
Business X =
Property A =
City B =
Property C =
City D =
EAT =
QI =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Buyer =

Dear ***:

This responds to your request for a private letter ruling, dated December 11, 2006. Specifically, you have asked us to rule that Taxpayer has complied with the requirements for identifying relinquished property set forth in Section 4.02(4) of Rev. Proc. 2000-37, 2000-2 C.B. 308.

FACTS

Taxpayer engages in Business X. Taxpayer uses the accrual method of accounting and its taxable year is the calendar year. Prior to the transactions described below, Taxpayer owned Property A, which is improved real property located in City B.

On Date 1, Taxpayer and an exchange accommodation titleholder (EAT) entered into a qualified exchange accommodation arrangement (QEAA) to set up an exchange pursuant to Rev. Proc. 2000-37 . Also on Date 1, Taxpayer assigned to EAT its rights as purchaser under a pre-existing purchase agreement for Property C, which is improved real property located in City D, and gave notice of the assignment to the sellers. Also on Date 1, EAT acquired Property C, pursuant to the QEAA.

On Date 2, Taxpayer entered into a sale contract, agreeing to sell Property A to Buyer. On Date 3, Taxpayer entered into an exchange agreement with QI as a qualified intermediary for a Â§ 1031 exchange with respect to Property A. Also on Date 3, Taxpayer assigned to QI its rights as seller under the Property A sales contract and gave notice of the assignment to Buyer.

On Date 4, the sale of Property A closed. Date 5, which was two days later and which happened to be a Sunday, was the 45th day following Date 1, the date on which EAT acquired Property C. On the day following (Date 6), Taxpayer sent EAT a signed document formally identifying Property A and other property as the possible relinquished properties in the exchange.

On or before Date 7 (the date which is 180 days after Date 1), QI will use exchange funds from the sale of Property A to acquire Property C from EAT as its replacement property.

APPLICABLE LAW

Section 1031(a)(1) of the Internal Revenue Code provides 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(a)(3) provides, in part, that for purposes of Section 1031(a) , any property received by the taxpayer is treated as property which is not like-kind property if 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.

Rev. Proc. 2000-37 provides a safe harbor under which the Internal Revenue Service will not challenge (a) the qualification of property as either "replacement property" or "relinquished property" (as defined in Section 1.1031(k)-1(a) of the Income Tax Regulations) for purposes of Section 1031

and the regulations thereunder or (b) the treatment of the EAT as the beneficial owner of such property for federal income tax purposes if the property is held in a QEAA as defined in section 4.02 of that revenue procedure.

One of the requirements set forth in Rev. Proc. 2000-37, which is stated at section 4.02(4), is that no later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the EAT, the relinquished property must be properly identified. Identification must be made in a manner consistent with the principles described in Section 1.1031(k)-1(c).

Section 1.1031(k)-1(c)(1) provides, in part, that replacement property is identified before the end of the identification period only if the requirements in Section 1.1031(k)-1(c)(1) are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

LEGAL ANALYSIS and CONCLUSION

For property to be eligible for use as relinquished property in an exchange within the safe harbor rules of Rev. Proc. 2000-37 , it must be identified within 45 days after the EAT acquires replacement property pursuant to a QEAA. Section 1.1031(k)-1(c) establishes the requirements for identifying replacement property in a deferred exchange. Under that regulation, any replacement property received within the 45-day identification period is treated as identified within the identification period. Applying that principle to a safe-harbor parking transaction under Rev. Proc. 2000-37 , relinquishing property through a qualified intermediary before the expiration of 45 days from the date that replacement property is parked, satisfies this identification requirement.

In the present case, Taxpayer disposed of Property A through QI less than 45 days following EAT's acquisition of Property C. The net proceeds from the sale of Property A were transferred to QI in its exchange accommodator role. Assuming QI is a qualified intermediary as defined in Section 1.1031(k)-1(g)(4) , QI may be used in the capacity of a qualified intermediary in a safe harbor parking transaction under the revenue procedure. Accordingly, provided QI is a qualified intermediary described Section 1.1031(k)-1(g)(4) , Taxpayer satisfied the identification requirements with respect to its exchange of Property A for Property C in accordance with section 4.02(4) of Rev. Proc. 2000-37 by disposing of Property A through QI within the 45-day identification period.

CAVEAT(S):

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. A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under Section 6110.

This ruling letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200329021

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: July 18, 2003
April 7, 2003

Section 1031 — Exchange of Property Held for Productive Use or Investment

Legend:

Taxpayer =
Parent =
Company =
LLC =
C Facility =
sub-facility =
State A =
State B =
State C =
Town X =
Date X =
Landlord =
Bank A =
$X =
$Z =
x =
Site Y =
Relinquished Property (RQ) =
Replacement Property (RP) =

Dear ***:

This responds to your letter, dated October 29, 2002, requesting a private letter ruling under §1031 of the Internal Revenue Code that no gain or loss will be recognized upon the conveyance of RQ and the receipt of RP.

APPLICABLE FACTS:

Parent is a publicly-traded State A corporation that is engaged in the business of owning and operating C Facilities. Parent is the sole shareholder of several subsidiaries, including Taxpayer. Taxpayer holds title to approximately 100 fee-owned properties improved with C Facilities. These C Facilities are operated by Parent, which compensates Taxpayer for the use of the facilities. Parent files a consolidated federal tax return that includes Taxpayer, as well as its other wholly-owned subsidiaries.

The only other party involved in the proposed exchange (besides an unidentified, unrelated party who will be the eventual transferee of RQ) is Company. Company will serve as both a qualified intermediary (QI) and an exchange accommodation titleholder (EAT) in the proposed transaction. Company also includes a special purpose limited liability company (LLC) that will be organized under the laws of State C. LLC will be wholly owned by Company, will be formed immediately prior to Company's acquisition of RP in its capacity as EAT and will be a disregarded entity.

Taxpayer proposes to exchange RQ for RP in a transaction intended to qualify for deferral under Â§1031. RQ is currently used in Taxpayer's business. Taxpayer intends to acquire RP for use in its business. The business purpose of the proposed transaction is to dispose of an existing sub-facility and acquire a newly constructed facility. Neither Taxpayer nor Parent have any current intention to sell or otherwise dispose of the RP after it is acquired. Taxpayer proposes to effect the exchange as follows:

On Date 1, Taxpayer will set up a qualified exchange accommodation arrangement (QEAA) by entering into an agreement (QEAA Agreement) with Company. Under the QEAA Agreement, LLC will accept an assignment from Parent, on the same date, of a Leasehold Interest in Site Y located in Town X, State B (the "Leasehold Interest"). Also, on or about Date 1, Taxpayer will enter into an exchange agreement with Company (the "Exchange Agreement").

The Leasehold Interest was never the property of Taxpayer. The Leasehold Interest was acquired by Parent on Date X under a ground lease with Landlord, who is unrelated to Parent and Taxpayer. Under the laws of State B, the Leasehold Interest is a real property interest.

When acquired on Date 1, Site Y will be unimproved except for demolition of the existing building on the site, and rough grading (all to be performed by Landlord). Under the ground lease, Parent acquired the right to occupy and use Site Y for a period of twenty (20) years with four (4) five-year renewal options and to construct on Site Y certain types of real property improvements, which would be owned by Parent or its assignee.

Under Parent's supervision, LLC will construct and own a single story x square foot C Facility building pursuant to plans and designs provided by Parent (the "Improvements"). The completion of the construction of the Improvements is anticipated to occur on Date 2 (a date within 180 days after

the earlier of the transfer of RQ to QI or the date LLC acquires title to the Leasehold Interest). Record title to the Leasehold Interest and Improvements will be held by LLC beginning on or about Date 1 until a date not later than Date 2. Under the QEAA Agreement, Taxpayer has the right and the obligation to acquire and take title to the Leasehold Interest and the Improvements from LLC on or before Date 2.

Under the Exchange Agreement, Taxpayer will assign to QI the right to sell RQ to an unrelated buyer, pursuant to the terms and conditions of a purchase (sale) agreement. On or about Date 1, Taxpayer will convey RQ to a buyer and the buyer will be notified in writing of Taxpayer's assignment of its contract rights to QI. At the time of the conveyance, RQ will not be encumbered by any indebtedness. The proceeds from the sale of RQ (the "qualified funds") will be held by QI and deposited to an account at Bank A in the sole name of QI. Under the Exchange Agreement, Taxpayer has no right to receive, pledge, borrow or otherwise receive the benefits of the qualified funds. Taxpayer will also make a written assignment to QI of its right to acquire the Leasehold Interest and Improvements under the QEAA Agreement, and QI will make monthly disbursements to LLC from the qualified funds to permit LLC to make payments to the general contractor constructing the Improvements. None of the qualified funds disbursed by QI to LLC to pay construction costs will be paid to Taxpayer or to Parent, except for the planning costs to be paid to Parent. [FN1]

Company is engaged in the business of providing exchange accommodation services as a qualified intermediary (QI) and as an exchange accommodation titleholder (EAT). Company is independent of and unrelated to Taxpayer and Parent and will be paid a fee for its services as QI and EAT.

Site Y, the intended site for the construction of Improvements, was originally ground leased to Parent by an unrelated person on arm's length commercial terms. The remaining term of the ground lease for the C Facility site will exceed thirty (30) years (including renewal options) when LLC, at the direction of QI, transfers title to the Leasehold Interest and the Improvements to Taxpayer on Date 2 to complete the exchange.
Under the QEAA Agreement, EAT and not the Taxpayer will report for federal and state income tax purposes the attributes of its ownership interest in the Leasehold Interest and the Improvements, as they are constructed during the 180-day safe harbor period. LLC will not file a tax return because it is a disregarded entity that is wholly owned by EAT (Company). During the period that LLC holds title to the Leasehold Interest, LLC will pay any rent and other leasehold charges that come due and LLC also will pay the real estate taxes that accrue during such period.
Under the Exchange Agreement, the Taxpayer will identify within the 45-day period set forth in Â§1031(a)(3) in a written instrument delivered to QI the legal description for the Leasehold Interest and a general description of the Improvements to be constructed on the Leasehold Interest, while it is owned by LLC.
Under the QEAA Agreement, the Taxpayer will identify, within the 45-day period beginning on Date 1, the RQ disposed of under the Exchange Agreement as the real property being exchanged for the RP held under the QEAA Agreement.

QI will not take title to either the RQ or to the RP. However, at both the closing of the disposition of the RQ and the subsequent closing of the acquisition of the RP, Taxpayer will give written notice, respectively, to the buyer of the RQ and to EAT (as the seller of the RP) of Taxpayer's assignments of its contract rights (to sell RQ and to buy RP) to QI, as permitted by Â§ 1.1031(k)-1(g)(4)(v).

Within one hundred eighty (180) days after the earlier of (i) the conveyance of the RQ, and (ii) LLC's acquisition of the RP in the form of the Leasehold Interest and Improvements, the Taxpayer will acquire under the Exchange Agreement and the QEAA Agreement the Leasehold Interest and the Improvements to complete the Exchange.

Under the QEAA Agreement, the purchase price to be paid by Taxpayer for the acquisition of RP will be equal to the costs incurred by LLC in constructing the Improvements and acquiring the Leasehold Interest, including capitalized costs such as accrued real estate taxes, rent and the planning costs. The final purchase price to be paid by Taxpayer will be determined immediately before Date 2.

To the extent the actual purchase price exceeds the qualified funds held by QI, the excess purchase price will be paid in cash by Taxpayer or will be paid by Taxpayer by assuming the outstanding indebtedness of LLC for the construction period expenses. To the extent the estimated cost of the Improvements is less than the qualified funds held by QI, if Taxpayer does not timely identify and acquire an additional like-kind replacement property, Taxpayer will receive the remaining qualified funds as boot.

APPLICABLE LAW:

General Requirements for Deferral under Â§1031.

Section 1031(a)(1) 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 that is to be held either for productive use in a trade or business or for investment. Thus, for a transaction to qualify under Â§1031, the properties must be: (1) exchanged; (2) held for productive use in a trade or business or for investment; and (3) of a like kind.

Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property as distinguished from a transfer of property for a money consideration only. See Â§1.1002-1(d) of the Income Tax Regulations. Under the given facts, there will be an exchange in which Taxpayer will receive property for property rather than money for property. The facts also indicate that both the property to be transferred as RQ and the property to be received as RP are properties held or to be held for use in Taxpayer's trade or business.

Section 1.1031(a)-1(b) of the regulations defines like-kind as referring to the nature or character of the property and not to its grade or quality. Section 1.1031(a)-1(c)(2) provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.
In the present case, Taxpayer is exchanging a fee interest in improved real estate for a long-term lease of a tract of land for a period of more than 30 years and improvements. Accordingly, the property to be transferred and the property to be received by Taxpayer are of like kind.

However, when the exchange is not simultaneous, the statute imposes additional conditions for satisfying the requirement that the exchanged property be of like kind.

Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) of the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

In addition, under general tax accounting principles, if money or other property is actually or constructively received by a taxpayer or an agent of a taxpayer before receiving like-kind replacement property, the disposition of the relinquished property will be treated as a sale under Â§ 1001. Because the transaction at issue in the present case has elements of both a deferred exchange and a reverse (or "parking") transaction, further provisions of the deferred exchange regulations at Â§ 1.1031(k)-1 and Rev. Proc. 2000-37, 2000-40 I.R.B. 308, are applicable for testing whether the transaction qualifies for deferral of gain (or loss) realized under Â§1031.

Applicable Deferred Exchange Regulations.

Section 1.1031(k)-1provides rules for deferred like-kind exchanges under Â§ 1031(a)(3). Section 1.1031(k)-1(a) provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held for productive use in a trade or business or for investment (the "replacement property"). In the case of a deferred exchange, if the requirements set forth in Â§ 1031(a)(3) (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property.

Section 1.1031(k)-1(c)(2) generally provides that replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer or any other person involved in the exchange other than the taxpayer or a disqualified person. Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements. Replacement property is identified only if it is unambiguously described. Real property is unambiguously described if it is described by a legal description, street address, or distinguishable name. However, Â§ 1.1031(k)-1(c)(1) provides, in part, that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

Section 1.1031(k)-1(d)(1) provides, in part, that the identified replacement property is received before the end of the exchange period if the taxpayer receives the replacement property before the end of the exchange period, and the replacement property received is substantially the same property as identified.

Section 1.1031(k)-1(e)(1) provides that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under Â§ 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of Â§1.1031(k)-1(e)(1), the terms "produced" and "production" have the same meanings as provided in Â§263A(g)(1) and the regulations thereunder. [FN2]

Section 1.1031(k)-1(e)(2) provides that in the case of replacement property that is to be produced, the replacement property must be identified as provided in Â§1.1031(k)-1(c) (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of Â§1.1031(k)-1(c)(3) (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

Section 1.1031(k)-1(e)(3)(i) generally provides that for purposes of Â§1.1031(k)-1(d)(1)(ii) (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified. Section 1.1031(k)-1(e)(3)(iii) further provides that if the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

Section 1.1031(k)-1(f)(1) generally provides that a transfer of relinquished property in a deferred exchange isnot within the provisions of Â§1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either Â§1031 (b) or (c). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides, in part, that except as provided in Â§1.1031(k)-1(g) (relating to safe harbors), for purposes of Â§1031 of the Code and Â§1.1031(k)-1 of the regulations, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to Â§1.1031(k)-1(k)) is actual or constructive receipt by the taxpayer.

Section 1.1031(k)-1(g)(2) through (g)(5) sets forth a variety of safe harbors for use in deferred exchange situations. The use of one or more of these safe harbors in a deferred exchange will shield a taxpayer from actual or constructive receipt of money or other property.

In the present case, Taxpayer will use the qualified intermediary safe harbor as described in Â§1.1031(k)-1(g)(4). Section 1.1031(k)-1(g)(4)(i) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of Â§1031(a). In such a transaction, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

Section 1.1031(k)-1(g)(4)(ii) states that the qualified intermediary safe harbor applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Â§1.1031(k)-1(g)(6).

Section 1.1031(k)-1(g)(4)(iii) defines the term "qualified intermediary" as a person, not the taxpayer or a disqualified person (as defined in Â§1.1031(k)-1(k)), who enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. [FN3]

Section 1.1031(k)-1(g)(4)(iv)(A) provides that, regardless of whether an intermediary acquires and transfers property under general tax principles, solely for purposes of Â§1.1031(k)-1(g)(4)(iii)(B), an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property. Section 1.1031(k)-1(g)(4)(iv)(B) provides that an intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person. Section 1.1031(k)-1(g)(4)(iv)(C) provides that an intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

Section 1.1031(k)-1(g)(4)(v) provides that solely for purposes of Â§1.1031(k)-1(g)(4)(iii) and (iv), an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

The Parking Transaction under Rev. Proc. 2000-37

Rev. Proc. 2000-37 sets forth a safe harbor for acquiring replacement property under a QEAA sometimes referred to as a "parking" transaction. As provided in this safe harbor, the Service will not challenge either (a) the qualification of the property as either replacement or relinquished property (as defined in Â§ 1.1031(k)-1(a)), or (b) the treatment of the EAT as the beneficial owner if the property is held in the QEAA as defined in section 4.02 of Rev. Proc. 2000-37. As provided in section 4.02 of the revenue procedure, property is held in the QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the EAT) who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of the entity is owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the EAT at all times from the date of acquisition by the EAT until the property is transferred as described in section 4.02(5) of Rev. Proc. 2000-37. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of beneficial ownership of property under applicable principles of commercial law (e.g., a contract for deed), or an interest in an entity that is disregarded as an entity separate *** from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the EAT, it is the taxpayer's bona fide intent that the property held by the EAT represent either replacement property or relinquished property in an exchange intended to qualify for nonrecognition of gain (in whole or in part) or loss under Â§ 1031;

(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the EAT, the taxpayer and the EAT enter into a written agreement (the "QEAA Agreement") providing that the EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Â§1031 and Rev. Proc. 2000-37 and that the taxpayer and the EAT agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. The agreement must specify that the EAT will be treated as the beneficial owner of the property for all

federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the EAT, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in Â§1.1031(k)-1(c). The taxpayer may properly identify alternative and multiple properties, as described in Â§1.1031(k)- 1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the EAT, (a) the property is transferred either directly or indirectly through a qualified intermediary (as defined in Â§ 1.1031(k)-1(g)(4)) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that relinquished property and replacement property are held in the QEAA does not exceed 180 days.

Pursuant to section 4.03 of Rev. Proc. 2000-37, property will not fail to be treated as held in the QEAA as a result of any one or more of the following legal or contractual arrangements (listed below, in part, as relevant to the given facts), regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An EAT that satisfies the requirements of the qualified intermediary safe harbor set forth in Â§1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under Â§1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnifies the EAT against costs and expenses;

(3) The taxpayer or a disqualified person loans or advances funds to the EAT or guarantees a loan or advance to the EAT; and

(4) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the EAT with respect to the property. [FN4]

APPLICATION AND ANALYSIS:

The proposed transaction involves a related party to Taxpayer (Parent) which provides by transfer to QI part of the property that is to become RP. [FN5] However, since both Taxpayer and Parent continue to be invested in exchange properties, both will remain so invested for a period of not less than two years following the exchange, and neither is otherwise cashing out its interests, gain recognition is not triggered under Â§1031(f)(4).

In addition, the qualified exchange accommodation arrangement safe harbor (the QEAA) provided by Rev. Proc. 2000-37 applies to the proposed transaction. Taxpayer will also use the qualified intermediary safe harbor as set forth in the deferred exchange regulations under Â§1.1031(k)-1(g)(4). In the present case, a qualified indicia of ownership of RP will be held by LLC in compliance with all requirements stated in section 4.02(1) of Rev. Proc. 2000-37. Taxpayer represents as its bona fide intent, now and at the time the qualified indicia of ownership of RP is transferred to LLC, that the property held by LLC will constitute replacement property in an exchange qualifying for nonrecognition of gain (in whole or in part) or loss under Â§1031, consistent with section 4.02(2) of Rev. Proc. 2000-37.

Within five days after the transfer of RP to LLC, Taxpayer will enter into a QEAA Agreement with an EAT providing that EAT (acting through LLC) will serve as EAT by acquiring RP as required by section 4.02(3) of Rev. Proc. 2000-37. Taxpayer represents that EAT (and LLC) will not be a disqualified person as defined by Â§1.1031(k)-1(k).

In addition, Taxpayer will enter into an exchange agreement with QI to facilitate transfer of RQ to a third party in the exchange transaction as permitted by Â§1.1031(k)-1(g)(4). Under this provision, QI will not be the agent of the taxpayer for purposes of Â§1031(a). Thus, Taxpayer's transfer of relinquished property through a qualified intermediary and the subsequent receipt or deemed receipt of like-kind replacement property through a qualified intermediary will be treated as an exchange.

All timing requirements necessary for property to be held in the QEAA, relating to notice and transfer of qualified indicia of ownership of the property to LLC will be satisfied. Within 45 days after the transfer of RP to EAT, Taxpayer will identify RQ as required by section 4.02(4) of Rev. Proc. 2000-37. Also, as required by section 4.02(5) of Rev. Proc. 2000-37, no later than 180 days after the transfer of qualified indicia of ownership of RP to LLC, RP will be transferred to Taxpayer. Consistent with section 4.02(6) of Rev. Proc. 2000-37, RQ will not be held by LLC or EAT in a QEAA and the total time that LLC will hold RP will not exceed 180 days. RP will be received by Taxpayer at or about the same time as the transfer of RQ to the third party through QI. Therefore, Taxpayer will receive RP before the earlier of: (1) 180 days after the date on which the taxpayer transfers RQ in the exchange, or (2) 180 days after the date on which RP is transferred to LLC pursuant to the QEAA agreement.

As permitted by section 4.02(1) of Rev. Proc. 2000-37, the qualified indicia of ownership of RP will be held by EAT through LLC, a disregarded entity it wholly owns. EAT is and will be subject to federal income tax and is not Taxpayer or a disqualified person. Parent will transfer Leasehold Interest to LLC. One or more contractors hired and supervised by LLC will construct improvements on such property. Leasehold Interest, together with such improvements constructed by and for LLC, will constitute RP. Once construction is completed, RP will be transferred to Taxpayer to complete the exchange.

Section 1.1031(k)-1(e)(1) provides that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under Â§1031 merely because RP is not in existence or is being produced at the time the property is identified as replacement property. Section

1.1031(k)-1(e)(2)(i) requires a taxpayer to identify RP by providing a legal description of the underlying land that is subject to sublease and as much detail as is practicable regarding the construction of the improvements at the site.

Taxpayer will receive no money or other property directly, indirectly or constructively prior to or during the exchange and will receive no economic benefit of money or property other than that derived from the exchange. One possible exception will be if other property is transferred to Taxpayer incident to the failure of the contractors to timely complete improvements on RP prior to its transfer to Taxpayer. In that event, Taxpayer will have taxable boot in addition to any like-kind replacement property received in the exchange. Also, to the extent the estimated cost of the Improvements is less than the qualified funds held by QI, if Taxpayer does not timely identify and acquire additional like-kind replacement property, Taxpayer will receive the remaining qualified funds as boot.

RULING:

Accordingly, based on the documents presented, including the exchange agreement with QI, the QEAA Agreement with EAT setting up the QEAA, and all other representations made, Taxpayer's transaction will conform with the requirements of the qualified intermediary and the QEAA safe harbor rules, so that QI and EAT will not be agents of Taxpayer and Taxpayer will not be in actual or constructive receipt of money or other property before receiving RP. Taxpayer will not recognize any gain or loss upon the conveyance of RQ to a third party and the receipt of RP. However, if planned improvements are not completed within the exchange period, gain will be recognized to the extent of any boot received in the exchange. Also, to the extent the estimated cost of the Improvements is less than the qualified funds held by QI, if Taxpayer does not timely identify and acquire additional like-kind replacement property, Taxpayer will receive the remaining funds as boot. Gain would then be recognized to the extent of such boot.

CAVEATS AND EXCEPTIONS:

Except as specifically provided above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, nor effects resulting from, the transaction that are not specifically covered by the above ruling. No opinion is expressed as to whether the accommodators used in this transaction are disqualified persons as defined in Â§ 1.1031(k)-1(k), as that would constitute essentially a factual determination. This ruling assumes that QI and EAT are eligible to serve as exchange accommodators.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) provides that it may not be cited as precedent. Pursuant to a Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representatives.

Sincerely yours,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel (Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200148042

Date:
August 29, 2001
Taxpayer =
Xcorp =
LLC =
Date X =

Dear

This responds to your letter dated February 26, 2001, as supplemented by your submission dated April 11, 2001 requesting rulings as to various factors relating to qualification of Taxpayer to serve as an exchange accommodation titleholder, pursuant to Rev. Proc. 2000-37, 2000-40 I.R.B. 308. The facts relating to your ruling application follow:

Xcorp is an entity engaged in the business of providing services as a facilitator of like-kind exchanges pursuant to § 1031(a)(3) of the Internal Revenue Code and § 1.1031(k)-1((g)(4) of the Income Tax Regulations. Taxpayer is a corporation affiliated with Xcorp. Taxpayer files its corporate tax return as part of a consolidated group of corporations with Xcorp. Taxpayer acts indirectly through its ownership of LLC, a Delaware limited liability company, as an exchange accommodation titleholder ("AT"), as that term is defined in Section 4 of Rev. Proc. 2000-37. LLC's role is to hold property for the benefit of customers to facilitate exchanges under § 1031 of the Code.

On Date X, Taxpayer (including LLC) entered into a qualified exchange accommodation agreement ("the QEA Agreement"), consistent with the requirements of the revenue procedure, with an exchange customer ("Customer"). Under the QEA Agreement, Taxpayer will facilitate an exchange for Customer using LLC as an AT. LLC will acquire and hold Replacement Property for Customer under a qualified indicia of ownership and then, within the exchange period provided in the revenue procedure, through a qualified intermediary, transfer Replacement Property to Customer in an exchange for Relinquished Property of Customer. The Relinquished Property will be transferred through the qualified intermediary to its ultimate buyer.[1]

However, it has come to Taxpayer's attention that the usefulness of the qualified exchange accommodation arrangements ("QEAAs") permitted under the revenue procedure is reduced because of concerns about duplicate transfer taxes on the transfer of legal title of Replacement Property from LLC to Customer (or the transfer of Relinquished Property to the ultimate buyer if the Relinquished Property is parked with LLC). To minimize this problem, Taxpayer revised ARTICLE SIX, Paragraph Q of the QEA Agreement to add the following language at the end of the paragraph:

[LLC] is acting solely as [Customer's] agent for all purposes, except for federal income tax purposes.

It is believed that in many jurisdictions, this express agency statement (for non federal income tax purposes) will help avoid additional transfer tax when, for example, LLC transfers legal title to property to its exchange customers.

Taxpayer requests that we rule that the addition of the language regarding agency for non federal income tax purposes will have no adverse affect on qualification of the QEA Agreement, between Taxpayer (including LLC) and Customer, as a qualified exchange accommodation agreement, as defined in Section 4.02 of the revenue procedure.

Section 4.02(3) of the revenue procedure requires that the qualified exchange accommodation agreement, entered into between an exchanging taxpayer and an AT, specify that the AT will be treated as the beneficial owner of the exchange property it receives by transfer for all federal income tax purposes. It further provides that the parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with that agreement.

If Customer enters into or uses all or most of the types of side agreements or arrangements permitted under Section 4.03 of the revenue procedure (i.e., an exchange agreement for AT to serve as a qualified intermediary, a guarantee and indemnity agreement, any agreement to loan or advance funds, a lease to disqualified persons, a management or construction agreement with disqualified persons, any other arrangement relating to the purchase or sale of the property (including put and call agreements at fixed or formula prices), or providing for variation of value so that the burdens and benefits of ownership are with Customer), the AT will likely be considered an agent of Taxpayer under state law. See discussion at Section 2.05 of the revenue procedure. However, Section 5.04 provides that property will not fail to be treated as being held in a QEAA merely because the accounting, regulatory, or state, local or foreign tax treatment between the taxpayer and the AT is different from the treatment required by Section 4.02 (3) of the revenue procedure.[2]

For Customer to obtain the benefits of the safe harbor rules of the revenue procedure, the transaction need only fit within the confines of the safe harbor rules. Assuming the boundaries of the safe harbor rules are not exceeded, Customer is entitled to enjoy the protection afforded to all compliant taxpayers by these rules, notwithstanding inconsistent treatment or characterization under state or local law. Thus, a statement in the QEA Agreement that LLC (whose activities and assets are attributed to Taxpayer) is acting as agent of Customer for all purposes other than federal income tax purposes, will not affect the qualification of the QEA Agreement or the QEAA.

Accordingly, the inclusion of a statement in the QEA Agreement that "[LLC] is acting solely as [Customer's] agent for all purposes except for federal income tax purposes" will have no adverse affect on the qualification of the QEA Agreement under Rev. Proc. 2000-37.

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Code or regulations that may be applicable or under other general principles of federal income taxation. Neither is any opinion is expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling.

Under the Power of Attorney Form 2848 on file with this office, we are sending this original letter to you and a copy to your representative stated on line 2 of the form.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.
Sincerely yours,

Associate Chief Counsel
(Income Tax & Accounting)
By: Robert M. Casey
Senior Technician Reviewer, Branch 3

PRIVATE LETTER RULING 200251008

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: December 20, 2002
September 11, 2002

Section 1031 — Exchange of Property Held for Productive Use or Investment

Legend:

CC:IT&A:4 -- PLR-106793-02
Taxpayer =
CorpW =
LLC-W =
Husband's Trust =
Husband =
Wife's Trust =
Wife =
Minority Member =
Holding Company =
QI =
EAT =
Titleholder =
Unimproved Real Property =
Relinquished Property or RQ =
Replacement Property or RP =
Business =
State A =
State B =
Village =
City =
County =
A-Acres =
$B =
C-Acres =
$D =
Bank =
$E =

Dear***:

This responds to your letter, dated January 29, 2002, requesting a ruling on the proper federal income tax treatment of a proposed like-kind exchange of real property, as supplemented by letters and submissions dated February 22, March 20, May 16, June 3, June 14, and August 9, 2002. Taxpayer requests a ruling under Section 1031 of the Internal Revenue Code that no gain or loss will be recognized upon the conveyance of Relinquished Property (RQ) to Village and the receipt of Replacement Property (RP).

APPLICABLE FACTS:

Taxpayer is an S corporation, organized under the laws of State A, which operates Business on a calendar year basis, using the accrual method of accounting. Business is situated on RQ. Taxpayer owns a fee interest in RQ, with all improvements thereon.

CorpW, an S corporation organized under the laws of State A, currently leases A-Acres situated on Unimproved Real Property located in City and County under a Lease and Development Agreement ("Lease"), as amended, with City. Lease's term is 45 years from the commencement date (which was on or about September 2, 1997), and one 15-year renewal option.

LLC-W, a State A limited liability company, subleases A-Acres from CorpW and all rights, title, interest and obligations under Lease, for the entire term of Lease. LLC-W plans to utilize A-Acres, in part, as the new location for Business that presently exists on RQ. LLC-W is currently developing and constructing the infrastructure required so that Business can be moved to A-Acres.

Taxpayer and CorpW are related parties, each owned half and half by Husband's Trust and Wife's trust, respectively. LLC-W is also related to Taxpayer, owned 45%, 45% and 10%, respectively, by Husband's Trust, Wife's Trust and Minority Member.

Village and Taxpayer entered into an Option Agreement for Sale and Purchase (Sale Agreement) of RQ on December 12, 2001, and December 13, 2001, respectively. Under Sale Agreement, Taxpayers agreed to sell RQ to Village for $B. However, Taxpayer is arranging to have this transaction (the transfer of RQ to Village) structured as a component of a like-kind exchange under Section 1031 of the Code. Taxpayer will structure the exchange

utilizing the qualified exchange accommodation arrangement (the QEAA) safe harbor provided in Rev. Proc. 2000-37, 2000-40 I.R.B. 308, with an exchange accommodation titleholder (EAT) and its wholly owned subsidiary, Titleholder.

Taxpayer will also use the qualified intermediary safe harbor rules of the deferred exchange regulations at Section 1.1031(k)-1(g)(4) of the Income Tax Regulations, by entering into an exchange agreement with a qualified intermediary (QI). EAT and QI are both State A limited liability companies, wholly owned by Holding Company, a State B limited Partnership. Initially, the QEAA will be between Taxpayer and EAT. Later, Taxpayer's rights under the QEAA will be assigned to QI to facilitate transfer of RP from EAT to Taxpayer. The additional entity mentioned above, Titleholder, will be established for this exchange transaction, specifically to take title to RP. Titleholder will be a limited liability company, with EAT as its sole member, and disregarded for federal income tax purposes.

The exchange will occur as follows: LLC-W will sublease C-Acres (which is part of A-Acres), at a market rental rate, for a fixed term of 32 years to Titleholder as part of the QEAA. EAT will cause Titleholder to construct RP improvements on C-Acres. Taxpayer will identify RQ within 45 days of Titleholder entering into the sublease as provided in Rev. Proc. 2000-37, in a manner consistent with Section 1.1031(k)-1(c).

Under the QEAA, Titleholder will enter into a contract with LLC-W (who will act as Construction Manager and contract on behalf of Titleholder with independent subcontractors) to construct RP improvements based on Taxpayer's plans and specifications. In addition, Titleholder will utilize the Bank Construction Loan (described below) to finance the construction of RP improvements by executing a note payable to Taxpayer, thereby obligating itself to pay Taxpayer for draw requests paid to Construction Manager. The cost to construct RP improvements will approximate $B.

The Bank Construction Loan, in the amount of $E, will be funded by Bank, with Taxpayer as maker and primary obligor. LLC-W and CorpW, together with Husband and Wife, will be guarantors of the Bank Construction Loan.

Subsequent to the commencement of the construction, Taxpayer will assign its rights under Sale Agreement of RQ to QI and give notice of such assignment to all parties to such agreement in writing, all as provided in Section 1.1031(k)- 1(g)(4)(v) of the regulations. Taxpayer will then transfer RQ to Village, as provided in the exchange agreement with QI. Taxpayer will retain liability on the underlying full recourse mortgage on RQ of approximately $D by agreement with Bank. RQ will then be transferred by QI to Village free and clear. Village will pay the purchase price for RQ to QI and QI will receive and hold in escrow the proceeds from the sale of RQ. RQ constitutes substantially all of Taxpayer's assets. Village will not assume any liabilities of Taxpayer incident to the purchase.

To complete the exchange, Taxpayer will assign its rights to receive RP under the QEAA to QI. Thereupon, QI will direct that EAT transfer RP directly to Taxpayer. EAT will effect this transfer by transferring all of its ownership interest in Titleholder directly to Taxpayer. Through this series of transactions, QI will purchase RP from EAT using all the proceeds from the sale of RQ. EAT (through Titleholder) will use all of the proceeds from the sale of RQ to pay Construction Manager for construction and services and pay the loan from Taxpayer in full. Taxpayer will use the repayment proceeds to fully pay Bank Construction Loan before EAT transfers Titleholder to Taxpayer.

Because Titleholder is a disregarded entity for federal tax purposes, EAT will be deemed to enter into any contract Titleholder enters into and to perform any activity Titleholder performs. Furthermore, a transfer of all the interest in Titleholder will be treated as a transfer of the assets of Titleholder. Therefore, any reference herein to the transfer of RP properly refers to the transfer of all the interests of EAT in Titleholder to Taxpayer.
None of the accommodators to be used to implement the proposed exchange (QI, EAT, Titleholder) are disqualified persons as defined in Section 1.1031(k)- 1(k). Also, EAT, Titleholder and QI are subject to federal income tax or, if such persons are treated as partnerships or S corporations for federal income tax purposes, more than 90% of its interest or stock are owned by partners or shareholders who are subject to federal income tax. Services to be performed for Taxpayer by EAT, Titleholder and QI, with respect to exchanges of property are intended to facilitate exchanges that qualify for nonrecognition of gain or loss under Section 1031.

No later than five business days after the transfer of a qualified indicia of ownership of exchange property (RP) to EAT, Taxpayer and EAT will enter into a written agreement (setting up the QEAA) providing that EAT is holding RP in order to facilitate an exchange under Section 1031 and Rev Proc. 2000-37, and that Taxpayer and EAT agree to report the acquisition, holding and disposition of the property as provided in that revenue procedure. The QEAA will specify that EAT will be treated as the beneficial owner of the property for all federal income tax purposes and that Taxpayer and EAT will report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the terms of the QEAA.
Pursuant to the QEAA, Taxpayer will exchange RQ for RP. RP will be real property that consists of a 32-year sublease of C-Acres and specifically identified buildings and improvements on C-Acres to be utilized as part of the relocated Business. The QEAA will also provide that Titleholder will enter into a fixed term 32-year sublease with LLC-W and pay rent to LLC-W at a market rate of rent for C-Acres of land, which is a portion of A-Acres. All improvements to be constructed on RP will be with the approval of City, County, and Bank where required.

No later than 180 days after the transfer of the qualified indicia of ownership of RP to Titleholder (wholly owned by EAT), Titleholder will be transferred directly to Taxpayer. If the production of the identified RP is not completed by Titleholder on or before the 180-day period has expired, EAT will be required by the agreement to transfer all of its interest in Titleholder prior to the completion to Taxpayer in order to comply with the requirements of Rev. Proc. 2000-37.

The agreement between Taxpayer and EAT will expressly limit Taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by EAT or Titleholder in a manner consistent with the requirements of Section 1.1031(k)-1(g)(4)(ii) and (g)(6). EAT will hold qualified indicia of ownership of RP, as defined in Rev. Proc. 2000-37, (through Titleholder) and such qualified indicia of ownership will be held by EAT at all times from the date of acquisition by EAT until the property is transferred to Taxpayer. At the time the qualified indicia of ownership of the property is transferred to EAT, it is Taxpayer's bona fide intent that the property held by EAT represent RP in an exchange that is intended to qualify for nonrecognition of gain (in whole or part) or loss under Section 1031.

In addition to entering into the QEAA, Taxpayer will enter into a written agreement, the exchange agreement, with QI. The exchange agreement will require QI to acquire RQ from Taxpayer and transfer RQ to a purchaser, and to acquire RP and transfer RP to Taxpayer. Pursuant to the exchange agreement, and as provided in Section 1.1031(k)-1(g)(4)(iv) and (v), Taxpayer will assign its rights under Sale Agreement (of RQ to Village) to QI, assign its rights under the QEAA to receive RP also to QI, and give proper and timely notice of these assignments to all parties of Sale Agreement and to all parties of the QEAA.

Pursuant to these agreements, assignments and notices, RQ will be transferred, through QI, to Village, and Taxpayer will receive, through QI, complete ownership of RP by the transfer of all ownership interest in Titleholder. The exchange agreement between Taxpayer and QI will also require that Taxpayer will have no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property (in particular the proceeds resulting from the sale of RQ to Village) held by QI except as provided in Section 1.1031(k)-1(g)(6). Furthermore, since Taxpayer will transfer RQ and receive RP simultaneously, the transaction will effectively satisfy the time requirements in Section 1031(a)(3). Also, RP will not remain in QEAA for a period exceeding 180 days.

The entire proposed transaction at issue can be summarized in the following steps: (1) Taxpayer will enter into the QEAA with EAT, and will enter into an exchange agreement with QI as described. (2) LLC-W will sublease RP at a fair market rental, for 32 years, to Titleholder, a disregarded entity wholly owned by EAT, as part of a QEAA as defined in Rev. Proc. 2000-37. (3) Taxpayer will lend to Titleholder the funds which it (Taxpayer) will borrow from Husband's Trust, Wife's Trust and Bank to construct improvements necessary on leased property for relocation of Business. (4) Taxpayer will assign its rights under Sale Agreement of RQ to QI and will give required notices of such assignment to all interested parties. (5) Taxpayer will transfer RQ free and clear through QI to Village, and QI will receive sales proceeds. (6) Taxpayer will assign its position in the QEAA to QI and give required notices of such assignment to all interested parties. (7) QI will use sales proceeds from RQ to pay EAT for all of its interest in Titleholder (which holds all of RP, consisting of leased property and newly constructed improvements to suit Taxpayer's business requirements). (8) EAT will use the proceeds received from QI (the consideration for the transfer of RP (Titleholder)) to pay Construction Manager and to pay the loan from Taxpayer in full (which Taxpayer will, in turn, use to pay the Bank Construction Loan in full). (9) QI will direct EAT to transfer its interest in Titleholder (holding RP) directly to Taxpayer.

APPLICABLE LAW:

General Requirements for Deferral under Section 1031.

Section 1031(a)(1) 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 that is to be held either for productive use in a trade or business or for investment.

In accordance with this provision, for a transaction to have the effect of deferring gain or loss under Section 1031, it must (1) constitute an exchange, (2) the property transferred and the property received must be held for productive use in a trade or business or for investment, and (3) the property exchanged must be of a like kind.

Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property as distinguished from a transfer of property for a money consideration only. See Section 1.1002-1(d) of the regulations. Under the given facts, there will be an exchange in which the taxpayer will receive property for property rather than money for property. The facts also indicate that both the property to be transferred as RQ and the property to be received as RP are properties held or to be held for use in Taxpayer's trade or business.

Section 1.1031(a)-1(b) of the Income Tax Regulations defines like-kind as referring to the nature or character of the property and not to its grade or quality. Section 1.1031(a)-1(c)(2) provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.

In the present case, Taxpayer is exchanging a fee interest in improved real estate for a long-term lease of a tract of land for a period of more than 30 years and improvements. Accordingly, such properties are of like kind for Â§1031 purposes, provided the requirements of Section 1031(a)(3) are satisfied.

Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) of the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

In addition, under general tax accounting principles, if money or other property is actually or constructively received by a taxpayer or an agent of a taxpayer before receiving like-kind replacement property, the disposition of the relinquished property will be treated as a sale under Â§1001 of the Code. Because the transaction at issue in the present case has elements of both a deferred exchange and a reverse (or "parking") transaction, further provisions of the deferred exchange regulations at Section 1.1031(k)-1 and Rev. Proc. 2000-37 are applicable for testing whether the transaction qualifies for deferral of gain (or loss) realized under Section 1031.

Applicable Deferred Exchange Regulations.

On April 25, 1991, the Service issued final regulations under Section 1.1031(k)- 1 providing rules for deferred like-kind exchanges under Section 1031(a)(3) of the Code. Section 1.1031(k)-1(a) of the regulations provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and

subsequently receives property to be held for productive use in a trade or business or for investment (the "replacement property"). In the case of a deferred exchange, if the requirements set forth in Â§1031(a)(3) (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property.

Section 1.1031(k)-1(c)(2) of the regulations generally provides that replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer or any other person involved in the exchange other than the taxpayer or a disqualified person. Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements. Replacement property is identified only if it is unambiguously described. Real property is unambiguously described if it is described by a legal description, street address, or distinguishable name. However, Section 1.1031(k)-1(c)(1) provides, in part, that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

Section 1.1031(k)-1(d)(1) of the regulations provides, in part, that the identified replacement property is received before the end of the exchange period if the taxpayer receives the replacement property before the end of the exchange period, and the replacement property received is substantially the same property as identified.

Section 1.1031(k)-1(e)(1) of the regulations provides that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under Section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of Section 1.1031(k)-1(e)(1), the terms "produced" and "production" have the same meanings as provided in Section 263A(g)(1) and the regulations thereunder.

Section 1.1031(k)-1(e)(2) provides that in the case of replacement property that is to be produced, the replacement property must be identified as provided in Section 1.1031(k)-1(c) (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of Section 1.1031(k)-1(c)(3) (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

Section 1.1031(k)-1(e)(3)(i) generally provides that for purposes of Section 1.1031(k)-1(d)(1)(ii) (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified. Section 1.1031(k)-1(e)(3)(iii) further provides that if the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

Section 1.1031(k)-1(f)(1) generally provides that a transfer of relinquished property in a deferred exchange is not within the provisions of Section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either Â§1031 (b) or (c). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides, in part, that except as provided in Section 1.1031(k)-1(g) (relating to safe harbors), for purposes of Section 1031 of the Code and Â§1.1031(k)-1 of the regulations, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to Section 1.1031(k)-1(k)) is actual or constructive receipt by the taxpayer.

Section 1.1031(k)-1(g)(2) through (g)(5) of the regulations sets forth a variety of safe harbors for use in deferred exchange situations. The use of one of more of these safe harbors in a deferred exchange will shield a taxpayer from actual or constructive receipt of money or other property.

In the present case, Taxpayer will use the qualified intermediary safe harbor as described in Section 1.1031(k)-1(g)(4) of the regulations. Section 1.1031(k)-1(g)(4)(i) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a). In such a transaction, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange and the determination of whether the taxpayer is in actual or onstructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

Section 1.1031(k)-1(g)(4)(ii) states that the qualified intermediary safe harbor applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

Section 1.1031(k)-1(g)(4)(iii) defines the term "qualified intermediary" as a person, not the taxpayer or a disqualified person (as defined in Section 1.1031(k)-1(k)), who enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(4)(iv)(A) provides that, regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of Section 1.1031(k)-1(g)(4)(iii)(B), an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property. Section 1.1031(k)-1(g)(4)(iv)(B) provides that an intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person. Section 1.1031(k)-1(g)(4)(iv)(C) provides that an intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

Section 1.1031(k)-1(g)(4)(v) provides that solely for purposes of Section 1.1031(k)-1(g)(4)(iii) and (iv), an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

The Parking Transaction under Rev. Proc. 2000-37.

On September 15, 2000, the Service issued Rev. Proc. 2000-37, 2000-40 I.R.B. 308, setting forth a safe harbor for acquiring replacement property under a QEAA sometimes referred to as a "parking" transaction. As provided in this safe harbor, the Service will not challenge either (a) the qualification of the property as either replacement or relinquished property (as defined in Section 1.1031(k)-1(a) of the regulations) or (b) the treatment of the EAT as the beneficial owner if the property is held in the QEAA as defined in section 4.02 of Rev. Proc. 2000-37. As provided in section 4.02 of the revenue procedure, property is held in the QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in section 4.02(5) of Rev. Proc. 2000-37. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of beneficial ownership of property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under Section 1031;

(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37 and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in Section 1.1031(k)-1(c). The taxpayer may properly identify alternative and multiple properties, as described in Section 1.1031(k)-1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in Section 1.1031(k)-1(g)(4)) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that relinquished property and replacement property are held in the QEAA does not exceed 180 days.

Pursuant to section 4.03 of Rev. Proc. 2000-37, property will not fail to be treated as held in the QEAA as a result of any one or more of the following legal or contractual arrangements (listed below, in part, as relevant to the given facts), regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in Section 1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under Section 1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;

(3) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder; and

(4) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property.

APPLICATION AND ANALYSIS:

The proposed transaction is a parking transaction between related parties (Taxpayer and LLC-W). The qualified exchange accommodation arrangement safe harbor (the QEAA) provided by Rev. Proc. 2000-37 applies to the proposed transaction. Taxpayer will also use the qualified intermediary safe harbor as set forth in the deferred exchange regulations under Section 1.1031(k)- 1, although the exchange itself is expected to be simultaneous.

In the present case, a qualified indicia of ownership of RP will be held by EAT in compliance with all requirements stated in section 4.02(1) of Rev. Proc. 2000-37. It is and will be Taxpayer's bona fide intent, now and at the time the qualified indicia of ownership of RP is transferred to EAT, that the property held by EAT represent replacement property in an exchange qualifying for nonrecognition of gain (in whole or in part) or loss under Section 1031, consistent with section 4.02(2) of Rev. Proc. 2000-37.

Within five days after the transfer of RP to EAT, Taxpayer will enter into the QEAA with an EAT providing that EAT (through Titleholder) will acquire RP as required by section 4.02(3) of Rev. Proc. 2000-37. Taxpayer represents that EAT will not be a disqualified person as defined by Section 1.1031(k)-1(k) of the Code.

In addition, Taxpayer will enter into an exchange agreement with QI to facilitate transfer of RQ to Village in the exchange transaction as permitted by Section 1.1031(k)-1(g)(4) of the regulations. Under this provision, a qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a). Thus, Taxpayer's transfer of relinquished property through a qualified intermediary and the subsequent receipt or deemed receipt of like-kind replacement property through a qualified intermediary is treated as an exchange.

All timing requirements necessary for property to be held in the QEAA, relating to notice and transfer of qualified indicia of ownership of the property to EAT, will be satisfied. Within 45 days after the transfer of RP to EAT, Taxpayer will identify RQ as required by section 4.02(4) of Rev. Proc. 2000-37.

Also, as required by section 4.02(5) of Rev. Proc. 2000-37, no later than 180 days after the transfer of qualified indicia of ownership of RP to EAT, RP will be transferred to Taxpayer. Consistent with section 4.02(6) of Rev. Proc. 2000-37, RQ will not be held by EAT in a QEAA and the total time that EAT will hold RP will not exceed 180 days. Moreover, RP will be received by Taxpayer simultaneously with its transfer of RQ through QI to Village. Therefore, Taxpayer will receive RP before the earlier of: (1) 180 days after the date on which the taxpayer transfers RQ in the exchange, (2) the due date (determined with regard to extension) for Taxpayer's tax return for the taxable year in which the transfer of RQ occurs, or (3) 180 days after the date on which RP is transferred to EAT under the QEAA.

As permitted by section 4.02(1) of Rev. Proc. 2000-37, the qualified indicia of ownership of RP will be held by EAT through Titleholder, another disregarded, single member LLC which it wholly owns. EAT is and will be subject to federal income tax and is not Taxpayer or a disqualified person. LLC-W is subleasing C-acres of the Unimproved Real Property to Titleholder. EAT and Titleholder will construct improvements on such property by one or more contractors hired and supervised by LLC-W. C-Acres (which is subleased from CorpW through LLC-W) together with such improvements, constructed by and for Titleholder, will constitute RP. Once EAT (and Titleholder through LLC-W) completes construction of improvements and the exchange of RP for RQ is completed, Taxpayer will take ownership of Titleholder (the disregarded entity holding title to RP).

Section 1.1031-1(e)(1) of the regulations provides that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under Section 1031 merely because RP is not in existence or is being produced at the time the property is identified as replacement property. Section 1.1031(k)-1(e)(1) requires a taxpayer to identify RP by providing a legal description of the underlying land that is subject to sublease and as much detail as is practicable regarding the construction of the improvements at the site. In the present case, however, the question of sufficiency of identification of replacement property does not arise because the exchange will be simultaneous, except to the extent the improvements to C-Acres are incomplete when RP is transferred to Taxpayer.

If the production of the identified RP is not completed by EAT on or before the date required to satisfy the requirements of Rev. Proc. 2000-37, EAT will be required by contract to transfer RP to Taxpayer to satisfy those requirements, prior to completion. If this occurs, the identification requirement will be satisfied because Taxpayer will receive RP simultaneously with its transfer of RQ.

Taxpayer will receive no money or other property directly, indirectly or constructively prior to or during the exchange and will receive no economic benefit of money or property other than that derived from the exchange. The only possible exception will be if other property is transferred to Taxpayer incident to the failure of the contractors to timely complete improvements on RP prior to the transfer of Titleholder to Taxpayer. In that event, Taxpayer will have taxable boot in addition to its like-kind replacement property.

RULING:

Accordingly, based on the documents presented, including the exchange agreement with QI, the qualified exchange accommodation agreement with EAT setting up the QEAA, and all other representations made, Taxpayer's transaction will conform with the requirements of the QI and the QEAA safe harbor rules, so that QI and EAT will not be agents of Taxpayer and Taxpayer will not be in actual or constructive receipt of money or other property before receiving RP. Taxpayer will not recognize any gain or loss upon the conveyance of RQ to Village and the receipt of RP. However, if planned improvements are not completed within the exchange period, gain will be recognized to the extent of any boot received in the exchange.

CAVEATS AND EXCEPTIONS:

Except as specifically provided above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, nor effects resulting from, the transactions that are not specifically covered by the above ruling. No opinion is expressed as to whether the accommodators used in this transaction are disqualified persons as defined in Section 1.1031(k)-1(k), as that would constitute essentially a factual determination. This ruling assumes that QI and EAT are eligible to serve as accommodators.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.
Pursuant to a Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representatives.

Sincerely yours,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel (Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200111025

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: March 16, 2001
December 8, 2000

Section 1031 — Exchange of Property Held for Productive Use or Investment

Legend:

Taxpayer =
State 1 =
State 2 =
State 3 =
Commercial =
Recreational =
City =
Accommodation Party =
Exchange Company =
Park =
Property =
Conservation Organization =
Bond Act =
Seller =
Bank =
Decade 1 =
Year 1 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Date 14 =
Date 15 =
Date 16 =
Date 17 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =
Amount 10 =
Amount 11 =
x portion =
y portion =
z portion =
Rate 1 =
Rate 2 =

Dear ***:

This letter ruling is in response to Taxpayer's letter, dated October 11, 2000 and submitted pursuant to Rev. Proc. 2000-1, 2000-1 I.R.B. 4, requesting rulings under Section 1031 of the Internal Revenue Code (Code).

Facts:

Taxpayer's business consists of real estate investment and leasing operations. Taxpayer owns and operates Commercial facilities located in State 1, State 2, and State 3. Taxpayer also owns a number of office buildings and recreational facilities, and a parking garage and two parking lots in City. Accommodation Party is engaged in the business of acquiring, owning, holding, leasing, financing, refinancing, and disposing of real property and its associated personal property. Accommodation Party is a single-member State 2 limited liability company that has not elected pursuant to Section 301.7701 of the Income Tax Regulations to be classified as an association. As a result, Accommodation Party is treated as a division or branch of its sole member, Exchange Company, a State 1 corporation. Neither Accommodation Party nor Exchange Company bears a relationship to Taxpayer that would result in either of them being treated as a "disqualified person" as defined in Section 1.1031(k)-1(k) of the regulations.

The Relinquished Property

Taxpayer, through its predecessor entity, acquired the Relinquished Property (the Park) in Decade 1. Since this acquisition, Taxpayer has held the Park as investment and rental property. During the past several years, Conservation Organization has indicated its ongoing interest in acquiring the Park for public parkland. Conservation Organization is an exempt organization under Section 501(c)(3) of the Code, which has among its purposes the acquisition of open space, scenic and recreational lands on behalf of the public.

Beginning in early Year 1, Conservation Organization and Taxpayer began serious discussions about entering into an agreement whereby Conservation Organization would have the option to acquire the Park under certain terms and conditions. Accordingly, after significant negotiations, Taxpayer and Conservation Organization entered into a Bargain Sale Option Agreement dated Date 1 (Option Agreement).

Upon execution of the Option Agreement, Conservation Organization paid Amount 1 to Taxpayer for an exclusive and irrevocable option to acquire all or some lesser portion of the Park for public, open space and recreational purposes (the Option). The all-cash purchase price under the Option Agreement is Amount 2 for the entire Park and if Conservation Organization elects to purchase a lesser portion, the purchase price is generally equal to 96% of the appraised value of such parcel. The Option was contingent upon, among other things, the passage by State 1 voters of the Bond Act. The initial term of the Option was through the earlier of Date 6 or the date the Bond Act failed to pass.

On Date 5, State 1 voters approved the Bond Act. As a result, the Option survived through Date 6. On Date 6, pursuant to a First Amendment to the Option Agreement, the initial option term was extended through Date 8 in consideration for Conservation Organization's cash payment to Taxpayer of Amount 3. Pursuant to this amendment, Conservation Organization's extended option term began on Date 9 and will expire on Date 14 in exchange for Conservation Organization's total cash payments of Amount 4 (Amount 5 was paid on Date 8 and Amount 6 will be due on Date 13, payable to an escrow holder for Taxpayer's benefit, unless Conservation Organization completes its purchase of all or some portion of the Park for an amount not less than Amount 7 on or before Date 12). These option payments are generally nonrefundable and will be credited against the purchase price for the Park when Conservation Organization exercises the Option.

The Option Agreement contains a tax-deferred exchange cooperation provision stating that Taxpayer has the right to effectuate a tax-deferred exchange, within the meaning of Section 1031, of all or any portion of the Park and that Conservation Organization will cooperate with Taxpayer to effectuate any such exchange. The provision also provides that if Taxpayer effectuates an exchange under Section 1031, title to the Park will be transferred to Conservation Organization by an accommodation party, and Conservation Organization agrees to accept title to the Park from such accommodation party as if title had been transferred to Conservation Organization directly from Taxpayer. Conservation Organization has also agreed to execute any and all documents which are reasonably necessary to carry out the tax-deferred exchange, and Taxpayer agrees to remain liable for its obligations under the Option Agreement after entering into any Section 1031 exchange. The Option Agreement further provides that all risk of loss with respect to the Park will remain with Taxpayer until the closing of Conservation Organization's purchase of all or a portion of the Park. Conservation Organization's eventual exercise of the Option and acquisition of the Park has been, and will continue to be subject to and contingent upon a number of public hearings and procedural steps, including, but not limited to: (1) the passage of the Bond Act, (2) gubernatorial budget proposal and State 1 legislative approval, (3) preparation of an appraisal prepared to governmental guidelines and approved by the acquiring agencies, (4) approval by public agencies of the value established by the appraisal; and (5) public hearings and preparation of numerous documents for public review and consideration.

The Replacement Property

On Date 11, Accommodation Party acquired the Replacement Property (the Property) pursuant to a Property Acquisition Agreement dated Date 3 by and between Accommodation Party and Seller and a Date 7 Amendment (Property Acquisition Agreement) for a total cash purchase price of Amount 8. Accommodation Party funded its purchase of the Property and the related transaction costs by borrowing Amount 9 from Bank and additional monies from Taxpayer pursuant to a full recourse line of credit, which provides for a loan to Accommodation Party of up to Amount 10 under certain terms and conditions.

The Bank loan (Bank Loan) dated Date 10 with Accommodation Party, as borrower, is secured by the Property and is also guaranteed by Taxpayer. Taxpayer's guaranty of the Bank Loan is evidenced by a payment guaranty and Taxpayer's environmental indemnification of Bank is evidenced by an indemnity agreement, each dated Date 10, and made by Taxpayer in favor of Bank. Accommodation Party has agreed to pay Taxpayer Amount 11 as a loan guaranty fee for Taxpayer's agreement to execute and deliver the Bank Loan payment guaranty. The Bank Loan bears interest at Rate 1 and is due on Date 15, subject to an optional three-month extension through Date 16. The Taxpayer loan made pursuant to a Loan Agreement between Taxpayer and Accommodation Party dated Date 4 (Taxpayer Loan) is unsecured and bears interest at Rate 2 calculated and compounded annually. The Taxpayer Loan is due on the earlier of the sale of the Property or Date 17. Accordingly, all of Accommodation Party's acquisition obligations bear interest at market rates.

Accommodation Party has leased the Property to Taxpayer pursuant to a Lease between Accommodation Party, as landlord, and Taxpayer, as tenant, dated Date 11. In addition to entering into the Lease with Taxpayer, Accommodation Party assigned its interest in certain leases and contracts that Accommodation Party acquired through its acquisition of the Property to Taxpayer and Taxpayer assumed the related liabilities from Accommodation Party.

Under the Lease, Taxpayer pays Accommodation Party a monthly base rent plus additional rent equal to all taxes, insurance and maintenance costs with respect to the Property. This rental provision is standard in the case of ""triple net" leases. The Lease has an initial one-year term with a one-year optional extension of the initial term. The amount of the rent exceeds Accommodation Party's cost of operating the Property (including debt service). Accommodation Party and Taxpayer have also entered into a Real Estate Acquisition Agreement dated Date 2, which was amended and restated on Date 11 (Taxpayer Acquisition Agreement). Pursuant to the Taxpayer Acquisition Agreement and subject to Taxpayer entering into the Lease, Accommodation Party entered into the Property Acquisition Agreement, the Bank Loan and the Taxpayer Loan (Accommodation Party Loans) to acquire the Property.

As long as Accommodation Party owns the Property, Accommodation Party and Taxpayer will report their related transactions for federal income tax purposes in accordance with its form, that is, Accommodation Party as the owner and lessor of the Property and Taxpayer as the lessee under the Lease and lessor under the subleases to customers of the Property.

Under the Taxpayer Acquisition Agreement, Taxpayer has an option to purchase (or acquire through a tax-deferred exchange) all or a portion of the Property for an amount equal to the fair market value of the designated portion of the Property. For this purpose, the fair market value of the Property (or any portion thereof) for any purchase by Taxpayer within eighteen months of the Property's acquisition by Accommodation Party is generally equal to Accommodation Party's cost of acquiring the Property.

In the event that the option is terminated, upon the occurrence of a certain specified event(s), Accommodation Party may sell the Property in conformity with the termination sale procedures set forth in the Taxpayer Acquisition Agreement. If Accommodation Party does not satisfy the termination sale procedures, upon its receipt of a termination notice, it will have the potential for exposure to economic loss. However, Accommodation Party is not obligated to sell the Property and may retain the Property free and clear of all obligations under the Taxpayer Acquisition Agreement. Thus, Accommodation Party has the potential to realize economic gain from its ownership of the Property.

If Accommodation Party elects to sell the Property, Taxpayer must reimburse Accommodation Party for x portion of net sale proceeds as compared to all acquisition and debt costs and fees and any other unreimbursed selling and closing costs and transfer taxes incurred by Accommodation Party. If the net sale proceeds exceed these costs, Accommodation Party may retain any such excess. In the event no offers or bids are received for the Property, or if for any reason the Property cannot be sold despite the good faith efforts of Accommodation Party to do so, the net sale proceeds are deemed to equal y portion and any charges and costs incurred by Accommodation Party in trying to sell the Property will increase the shortfall, which must be reimbursed in z portion by Taxpayer.

The Taxpayer Acquisition Agreement includes a general environmental release and indemnification of Accommodation Party and its affiliates by Taxpayer. The Taxpayer Acquisition Agreement also includes a "Tax Deferred Exchange" provision stating Taxpayer's right to effectuate a Section 1031 exchange for all or any portion of the Property. Under the provision, Accommodation Party agrees to cooperate with Taxpayer to effectuate any and all such exchanges and Taxpayer agrees to indemnify, defend and hold Accommodation Party harmless from any losses incurred by Accommodation Party as a result of any such exchange. The provision also provides that Accommodation Party understands and consents to any assignment by Taxpayer of its rights and responsibilities under the Taxpayer Acquisition Agreement to a qualified intermediary selected by Taxpayer and that Accommodation Party agrees to execute all documents reasonably required to carry out any such Section 1031 exchange.

The Deferred Exchange of the Park for the Property

Since the inception of this transaction, Taxpayer has intended to exchange the Park for all or a portion of the Property in a tax-deferred exchange under Section 1031. As soon as Conservation Organization is in a position to acquire the Park under the Option, Taxpayer will assign all of its rights in the Option Agreement and transfer the Park to a qualified intermediary within the meaning of Â§ 1.1031(k)-1(g)(4) of the regulations (the QI). The QI will then sell the Park to Conservation Organization pursuant to the Option Agreement and take receipt of all sale proceeds with respect to such sale.

Within 45 days after the transfer by Taxpayer of the Park to the QI, Taxpayer will identify all or a portion of the Property as like-kind replacement property in accordance with Section 1031(a)(3)(A). The QI will acquire the identified Property from Accommodation Party pursuant to an assignment of all of Taxpayer's rights under Taxpayer's option in the Taxpayer Acquisition Agreement and transfer the acquired Property to Taxpayer before the earlier of (i) 180 days after Taxpayer's transfer, or (ii) the due date (including extensions) of Taxpayer's return for the year in which Taxpayer's transfer occurred. Taxpayer intends to hold the Property for use as rental real property.

Rulings Requested:

(1) Taxpayer's exchange of the Park for the Property will qualify for nonrecognition treatment under Section 1031.

(2) The portion of the Property to be acquired in exchange for the Park will qualify as "replacement property" as defined in Section 1.1031(k)-1(a) of the regulations.

Law And Analysis:

Section 1031(a)(1) provides that no gain or loss will be 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 a like kind which is to be held either for productive use in a trade or business or for investment.

Under Section 1.1031(a)-1(b) of the regulations relating to the meaning of the term "like-kind," real property is generally considered to be like kind to all other real property, whether or not any of the real property is improved.

Section 1031(a)(3) provides certain requirements for treating property received in a nonsimultaneous exchange as like-kind property to the relinquished property. Under Section 1031(a)(3), any property received by the taxpayer (the "replacement property") will not be like kind to the relinquished property transferred if the replacement property (a) is not identified within 45 days of the taxpayer's transfer of the relinquished property, or (b) is received after the earlier of (i) 180 days after the taxpayer's transfer, or (ii) the due date (including extensions) for the taxpayer's return for the year in which the taxpayer's transfer occurred.

Section 1.1031(k)-1 of the regulations provides guidance on "deferred exchanges." These regulations specify in detail the circumstances in which deferred exchanges will be accorded nonrecognition treatment. Specifically omitted from such guidance is any application of these regulations to "reverse exchanges." T.D. 8346, 1991-1 C.B. 150, 151 (April 25, 1991).

On September 15, 2000, the Service issued Rev. Proc. 2000-37, 2000-40 I.R.B. 308, setting forth a safe harbor for reverse like-kind exchanges under Section 1031. Under the Rev. Proc. 2000-37 safe harbor provisions, the Service will not challenge either (a) the qualification of the property as either replacement or relinquished property (as defined in Section 1.1031(k)-1(a) of the regulations) or (b) the treatment of the exchange accommodation titleholder as the beneficial owner if the property is held in a "qualified exchange accommodation arrangement" (a QEAA).

Rev. Proc. 2000-37 is effective for QEAAs entered into on or after September 15, 2000. Rev. Proc. 2000-37 provides that "no inference" is intended with respect to the federal income tax treatment of similar arrangements entered into prior to or after its effective date. Further, the Service stated that it recognizes that "parking" transactions can be accomplished outside of the safe harbor provided in the revenue procedure. Section 3.02 of Rev. Proc. 2000-37.

Rev. Proc. 2000-37 does not apply to Taxpayer's transaction. First, Accommodation Party's acquisition of the Property predates the effective date of Rev. Proc. 2000-37. Second, even if Rev. Proc. 2000-37 applied to the transaction, Accommodation Party acquired the Property on Date 11, which will be more than 180 days before the transfer of the Property to Taxpayer.

Courts have permitted taxpayers significant latitude in structuring tax-deferred like-kind exchanges. See Starker v. United States, 602 F.2d 1341 (9th Cir. 1979) (transfers need not occur simultaneously); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963) (tax consequences depend on what the parties intended and accomplished rather than the separate steps); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963) (parties can amend a previously executed sales agreement to provide for an exchange), rev'g 38 T.C. 215 (1962); Barker v. Commissioner, 74 T.C. 555 (1980) (a party can hold transitory ownership of exchange property solely for the purposes of effecting the exchange). A taxpayer can locate suitable replacement property to be received in an exchange and can enter into negotiations for the acquisition of such property. See Coastal Terminals; Alderson; Coupe v. Commissioner, 52 T.C. 394 (1969), acq. in result only, 1970-2 C.B. xix. A taxpayer can also oversee improvements on the replacement property to be acquired, and can even advance funds toward the purchase of the replacement property to be acquired by exchange. See J.H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4, Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980), aff'g 69 T.C. 905 (1978).

Case law authority also exists for treating a reverse exchange as a qualifying like-kind exchange under Section 1031. In Rutherford v. Commissioner, T.C. Memo 1978-505, taxpayer, a farmer engaged in the cattle breeding business, entered into an agreement with another farmer whereby farmer would transfer 12 half-blood heifers to taxpayer who, at his own expense, would have the heifers artificially inseminated with the sperm of a registered bull. Once the first 12 three-quarter blood heifers were born, taxpayer would deliver the heifers to farmer. The agreement provided for no monetary payments.

Pursuant to their agreement, farmer delivered the half-blood heifers to taxpayer in November 1973. Taxpayer satisfied his obligation by delivering the three-quarter-blood heifers to farmer over a several year period beginning with four heifers in 1975, three in 1976 and five in 1977. The Tax Court determined that taxpayer had successfully completed a tax-deferred exchange under Section 1031 by his transfer of the relinquished property (the three-quarter blood heifers) for the replacement property (the half-blood heifers). Thus in the qualifying "reverse exchange," taxpayer received the replacement property before the relinquished property was even conceived.

Similarly, in Biggs, the Tax Court and the Fifth Circuit found that taxpayer's "reverse exchange" of two parcels of land located in Maryland for four parcels of land located in Virginia qualified under Section 1031. Taxpayer advanced monies to Shore Title Company, which was owned and controlled by taxpayer's attorney, to buy the Virginia properties (the replacement property) from a fourth party before the Maryland properties (the relinquished property) were sold. In addition to advancing acquisition funds to Shore, taxpayer directly paid the finder's fee and all of the closing costs to acquire the replacement property. Several months later, taxpayer transferred his relinquished property to the second party and received back his advanced funds. Shore then transferred the replacement property to taxpayer.

The Service contended that the exchange did not qualify under Section 1031, because Shore served as an agent for taxpayer throughout the transactions. The Service argued that because Shore acted as taxpayer's agent, taxpayer "merely effected an exchange with himself." Both courts rejected the Service's characterization of Shore as taxpayer's agent and concluded that the fact that Shore was used to facilitate the exchange did not mean that Shore was taxpayer's agent. In their respective decisions, the Tax Court and the Fifth Circuit each held that the exchange qualified under Section 1031 because (a) taxpayer always intended to enter into a tax-deferred exchange; (b) the various transfers were all interdependent and integrated parts of a single overall plan, and (c) Shore was not acting as taxpayer's agent.

Moreover, in J.H. Baird Publishing Co. and Coastal Terminals, the Tax Court and the Fourth Circuit, respectively, approved qualifying Section 1031 exchanges where the replacement property was acquired by a third party at the taxpayer's direction for the pre-exchange completion of significant improvements. After completion of the taxpayer-directed construction, the newly constructed property was acquired by the taxpayer as replacement property and in each case qualified under Section 1031.

In J.H. Baird, the Board of Directors of a Sunday school desired to acquire a building owned by J.H. Baird Publishing Co. Baird, however, only wanted to exchange its property in a tax-deferred exchange. To accomplish Baird's and the Board's goals, the parties entered into certain agreements with Realty Co. As a result and at Baird's direction, on October 15, 1956, Realty acquired an appropriate vacant lot. On October 31, 1956, Realty Co. sold Baird's relinquished property to the Board. The sale proceeds from the relinquished property went into a Realty Co. escrow account for Baird and the monies were used by Realty Co. to construct the replacement property. Meanwhile, Baird continued to occupy the relinquished property rent-free until the replacement property was completed. After completion of the new building in 1957, Baird received title to the replacement property and some excess cash from Realty Co. in exchange for the previously transferred relinquished property.

The Service denied like-kind exchange treatment on the grounds that there could not have been an exchange because Realty Co. was acting as Baird's agent. The Service contended that Realty Co., acting as Baird's agent, had sold Baird's relinquished property and with the sale proceeds had acquired and built a new property for Baird at his direction. Accordingly, the Service concluded that no exchange occurred.

In its decision, the Tax Court reviewed the concept of agency and found that an agency relationship is based upon a contract, either express or implied, between parties and that the contract here did not purport to create an agency. The court also acknowledged that the facts and circumstances indicated that an agency relationship did not exist. Thus, even though Realty Co. (i) held the relinquished property sale proceeds in an escrow account for Baird; (ii) agreed to build the replacement property on a vacant lot according to specifications approved by Baird; and (iii) agreed to transfer the completed replacement property plus any excess cash from the sale of Baird's property to Baird in exchange for Baird's property, the Tax Court found that Realty Co. was not acting as Baird's agent, but rather Realty Co. was acting on its own behalf as a principal.

An agency analysis, therefore, underlies the determination of whether or not an exchange occurred. The concept of agency is also inherent in the Section 1.1031(k)-1 regulations, which provide for the use of a qualified intermediary as a safe harbor. The regulations respect the qualified intermediary as a bona fide party to the exchange and not as the agent of the taxpayer. See Section 1.1031(k)-1(g)(4)(i).

While taxpayer attempts to convert independent purchase and sale transactions into reverse exchanges have failed, these cases are distinguishable from the foregoing taxpayer favorable cases. See, e.g., Bezdjian v. Commissioner, 845 F.2d 217 (9th Cir. 1988), aff'g T.C. Memo 1987-140; Lee v. Commissioner, T.C. Memo 1986-294; Dibsy v. Commissioner, T.C. Memo 1995- 477; Lincoln v. Commissioner, T.C. Memo 1998-421. In each of these failed reverse exchange cases, the taxpayers merely purchased one property and subsequently sold another property to a different party. The complete lack of contractual interdependence between each property purchase and sale forecloses any argument for exchange treatment, regardless of whether the purported exchange would be a reverse, simultaneous or deferred exchange. In these situations, the taxpayers' steps were not an interrelated exchange transaction.

The recent Tax Court decision in DeCleene v. Commissioner, 115 T.C. No. 34 (2000), is also distinguishable from the present case. Although the court analyzed the case as if it involved a "reverse exchange," it held that the underlying transaction did not involve a like-kind exchange.

In the DeCleene case, taxpayer acquired the Lawrence property in 1992. Approximately one year later, taxpayer transferred the Lawrence property to Western Lime and Cement Co. (WLC) in exchange for a nonrecourse note and, three months later, received back the Lawrence property in exchange for the McDonald property and payment on the note. The court held that WLC did not acquire any of the benefits and burdens of ownership of the Lawrence property and, therefore, the Lawrence property was never transferred to WLC. If the Lawrence property was never transferred to WLC, then the only way in which the transaction could qualify for nonrecognition under Section 1031 would be if the acquisition of the Lawrence property in 1992 was treated as part of an integrated plan to exchange it for the McDonald property. However, because at the time of the acquisition of the Lawrence property, taxpayer had not taken any steps to evidence an intent to enter into an exchange, such an integrated plan did not exist. As a result, the court did not reach the issue of the circumstances under which a parking transaction that is entered into as part of an integrated plan to accomplish a like-kind exchange qualifies for nonrecognition under Section 1031.

In Commissioner v. Bollinger, 485 U.S. 340 (1988), the Supreme Court reaffirmed its agency analysis set forth in National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949). The Supreme Court's agency analysis has four factors and two requirements, "the sum of which has become known ... as the "six National Carbide factors."D' Bollinger, 485 U.S. at 346. The Supreme Court's National Carbide factors are as follows:

(1) Whether the party in question operates in the name and for the account of the principal;

(2) binds the principal by its actions;

(3) transmits money received to the principal; and,

(4) whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal.

(5) The agency-principal relationship cannot be founded solely on the fact that the principal owns the agent. For example, a corporation will in most cases be treated as a taxable entity separate from its sole stockholder.

(6) The business purpose of the party in question must be the carrying on of the normal duties of an agent. National Carbide Corp., 336 U.S. at 437.

The foregoing authorities present three general requirements for an exchange to be recognized as a like-kind exchange under Section 1031 in similar situations:

(1) the taxpayer must demonstrate its intent to achieve an exchange and the properties to be exchanged must be of like kind and for a qualified use;

(2) the steps in the various transfers must be part of an integrated plan to exchange the relinquished property for the replacement property; and

(3) the party holding the replacement property must not be the taxpayer's agent.

Intent to Exchange

First, a taxpayer must intend to enter into an exchange of property for like-kind property each used by the taxpayer in a trade or business or held as an investment. See Coastal Terminals ("[w]hether the transaction constituted a sale or exchange for income tax purposes depends on the intent of the parties and this intent is to be determined from all relevant facts and circumstances," quoting Sarkes Tazian, Inc. v. United States, 240 F.2d 467, 470 (7th Cir. 1957)); Biggs (taxpayer insisted at all times that he receive like-kind property as part of the consideration for the transfer of the Maryland property); Baird (parties intended, and the contract provided for, an exchange); Rutland v. Commissioner, T.C. Memo 1977-8 (transaction qualified for Section 1031 treatment because the parties intended to effect an exchange and an exchange occurred); Fredericks v. Commissioner, T.C. Memo 1994-27 (taxpayer's intent to exchange property was evidenced by the documentation of the parties' agreement).

In this case, Taxpayer has evidenced its clear and consistent intent to exchange the Park for the Property in a transaction qualifying under Section 1031. Taxpayer has consistently insisted from the beginning of its transaction that the exchange of the Park for the Property must be structured as a tax-deferred exchange of like-kind property. Taxpayer has evidenced this intent by its inclusion of "tax-deferred exchange cooperation provisions" in each of the Conservation Organization Option Agreement, the Property Acquisition Agreement, and the Taxpayer Acquisition Agreement. As soon as Conservation Organization exercises its option to purchase the Park (which will be accomplished by using a qualified intermediary), Taxpayer will take the steps outlined above to effect a tax-deferred exchange of the Park for the Property in accordance with Section 1031(a)(3) and Section 1.1031(k)-1 of the regulations. Moreover, the Park and the Property are like-kind property under Section 1.1031(a)-1(b) and Taxpayer has held the Park as rental and investment property and will hold the Property as rental property after the completion of the exchange.

Interdependent and Integrated Overall Plan

Second, the steps in the various transfers must be interdependent and integrated parts of a single overall plan to achieve an exchange. See, e.g., Biggs, 632 F.2d at 1177-1178 (the many transactions leading to the ultimate transfers of the Maryland and Virginia properties were part of a single, integrated plan, the substantive result of which was a like-kind exchange); Coastal Terminals, 320 F.2d at 337 ("the transaction must be viewed as a whole ...", quoting Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945)); Fredericks v. Commissioner, T.C. Memo 1994-27 (taxpayer structured an integrated four party exchange). Taxpayer has entered into the series of steps described above as part of its overall plan to exchange the Park for the Property. Taxpayer has specifically designed and entered into each of the Conservation Organization Option Agreement and the Taxpayer Acquisition Agreement with Accommodation Party to achieve its overall plan of exchanging the Park for the Property. The overall substance of Taxpayer's series of transactions, which have been specifically designed and executed as parts of an overall unitary plan, is Taxpayer's exchange of the Park for the Property.

Accommodation Party Not Taxpayer's Agent

Moreover, under the Supreme Court's agency analysis, Taxpayer's relationship with Accommodation Party is not an agency relationship. In accordance with the Supreme Court's agency analysis, we apply the National Carbide factors to the facts of Taxpayer's transaction and its relationship with Accommodation Party. With respect to the first factor, Accommodation Party has operated and will operate in its own name and for its own account. The Operating Agreement of Accommodation Party states "[a]ll business of Accommodation Party will be conducted in the Accommodation Party name" and that "Accommodation Party will own and hold title to all of its property in the name of Accommodation Party." Consistent with its operating agreement, Accommodation Party entered into the Property Acquisition Agreement, the Taxpayer Acquisition Agreement, the Lease, the Bank Loan, and the Taxpayer Loan each in its own name and each for its own account. Accommodation Party operates its business through its own bank accounts, which are held in its name and for its account. In none of the operative documents is Accommodation Party referred to as Taxpayer's agent.

With respect to the second factor, Taxpayer has not contractually authorized Accommodation Party to bind Taxpayer by Accommodation Party's actions.

With respect to the third factor, Accommodation Party does not transmit money it receives for its account to Taxpayer. Under the Lease, Taxpayer is obligated to pay Accommodation Party a monthly base rent for Accommodation Party's account.

Applying the fourth factor, Accommodation Party's rental income under the Lease is pursuant to its lessor-lessee relationship with Taxpayer and Accommodation Party's ownership of the Property. Taxpayer's rental income from the subtenants under the subleases is pursuant to Accommodation Party's assignment of such subleases to Taxpayer under the assignments of lessor's interests in leases and assumption of liability under the leases.

The fifth factor is that "the agency relationship must not be dependent upon the fact that the principal owns it." Accommodation Party and Taxpayer are separate legal entities. Neither Accommodation Party nor Exchange Company is owned by or related to Taxpayer. Furthermore, as demonstrated by the preceding analysis, Accommodation Party is not acting on behalf of Taxpayer, but rather is acting for its own account. Exchange Company, as the sole member of Accommodation Party, will report Accommodation Party's rental income and expenses on its tax returns.

With respect to the sixth factor, Accommodation Party's business purpose is not to carry on the normal duties of an agent. As stated in its operating agreement and as demonstrated by its actions, (1) Accommodation Party is engaged in the business of acquiring, owning, holding, leasing, financing, refinancing and disposing of real property and its associated personal property and (2) Accommodation Party will conduct its business and will hold title to all of its property in its own name and for its own account.

Further, the Tax Court has consistently held that the fact that an accommodator is used to facilitate a like-kind exchange does not mean that the accommodator is an agent of the taxpayer. For example, in Baird, the sale proceeds were held in an account "under the name of Realty, Escrow Agent for Baird" and Baird had to approve all construction and related invoices. Similarly, in Fredericks, the accommodator acquired title to the relinquished property and the replacement property and obtained financing and constructed improvements for the purpose of facilitating the taxpayer's like-kind exchange. Thus, the fact that Accommodation Party is facilitating Taxpayer's exchange of the Park for the Property does not mean Accommodation Party is Taxpayer's agent.

Accordingly, Accommodation Party is not Taxpayer's agent.

Based on the foregoing analysis and Taxpayer's representations, we rule as follows:

(1) Taxpayer's exchange of the Park for the Property will qualify for nonrecognition treatment under Section 1031.

(2) The Property will qualify as "replacement property" as defined in Section 1.1031(k)-1(a) for purposes of Section 1031 and the regulations thereunder.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Associate Chief Counsel
(Income Tax & Accounting)
By:
Kelly E. Alton
Senior Technician Reviewer, Branch 5
This document may not be used or cited as precedent.

TECHNICAL ADVICE MEMORANDUM 200039005

Internal Revenue Service (I.R.S.)
Technical Advice Memorandum (TAM)
Issue: September 29, 2000
May 31, 2000

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Taxpayer =
A =
B =
S =
Relinquished Property =
Replacement Property =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

ISSUE:

Under the facts of this case, does the transaction constitute a deferred exchange and thus qualify for nonrecognition as a like kind exchange?

CONCLUSION:

The transaction does not constitute a deferred exchange, but rather, a purchase by Taxpayer of Replacement Property through the use of an agent, A, and a subsequent sale of Relinquished Property. It does not constitute an exchange eligible for nonrecognition under Internal Revenue Code Section 1031(a) as a like kind exchange.

FACTS:

Taxpayer intended to engage in a deferred like kind exchange of its Relinquished Property for an accommodator's Replacement Property. The plan was for Taxpayer to assign the contract of sale of Relinquished Property to the accommodator who would sell Relinquished Property and use the proceeds to acquire Replacement Property from S, the seller of Replacement Property. Taxpayer would then have the accommodator transfer Replacement Property to Taxpayer to complete the exchange. However, at closing the attempted sale of Relinquished Property fell through. Nevertheless, S demanded that closing on the acquisition of Replacement Property be completed immediately. Therefore, prior to contracting the sale of Relinquished Property, Taxpayer closed on the purchase of Replacement Property on Date 1, but had the property titled to A, an accomodator. Taxpayer negotiated the purchase; Taxpayer provided the funds; Taxpayer was personally liable on the purchase money mortgage while A was not. Taxpayer ordered that Replacement Property be titled to A. There is no evidence that A would have been involved in the transaction but for Taxpayer. On Date 2, Taxpayer contracted to sell Relinquished Property to B. Taxpayer then entered into an exchange agreement with A and assigned the contract of sale to A. On Date 3, A closed on the sale of Relinquished Property to B, and on Date 4, A transferred part of Replacement Property to Taxpayer. On Date 5, A transferred the remainder of Replacement Property to Taxpayer.

LAW AND ANALYSIS:

Section 1031(a)(1) of the Code provides 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 1.1031(k)-1 of the Income Tax Regulations provides safe harbor rules for the application of Section 1031 and the regulations thereunder to "deferred exchanges". Section 1.1031(k)-1(a) defines a deferred exchange as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

The threshold question, therefore, is whether a taxpayer engaging in a reverse deferred exchange (a so-called reverse-Starker exchange) can take advantage of the safe harbors available in Section 1.1031(k)-1. See Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). In particular, this transaction presents the question whether the safe harbor contained in Section 1.1031(k)-1(g)(4)(i) applies. This safe harbor provides, in part, that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a). If A is not considered an agent of Taxpayer, then it follows that Taxpayer did not acquire property through the agency of A.

The preamble to T.D. 8346,1991-1 C.B. 150, which promulgated Section 1.1031(k)-1, states that the final regulations do not apply to reverse-Starker exchange transactions.

The preamble states —

Section 1031(a)(3) of the Code and Section 1.1031(a)-3 of the proposed regulations apply to deferred exchanges. The proposed regulations define a deferred exchange as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). The proposed regulations do not apply to transactions in which the taxpayer receives the replacement property prior to the date on which the taxpayer transfers the relinquished property (so-called reverse-Starker transactions). See Starker v. United States, 640 F.2d 1341 (9th Cir. 1979).

The Service requested comments on whether reverse-Starker transactions should qualify for tax-free exchange treatment under any provision of section 1031. The comments received ranged from advocating the application of the deferred exchange provisions of section 1031(a)(3) to these transactions to advising that these transactions should not qualify for tax-free exchange treatment under either the general rule set forth in section 1031(a)(1) or section 1031(a)(3). After reviewing the comments and the applicable law, the Service has determined that the deferred exchange rules of section 1031(a)(3) do not apply to reverse-Starker transactions. Therefore, the final regulations, like the proposed regulations do not apply to reverse-Starker transactions. However, the Service will continue to study the applicability of the general rule of section 1031(a)(1) to these transactions.

Therefore, it is clear that the Section 1.1031(k)-1 regulations and, consequently, the safe harbors of Section 1.1031(k)-1, do not apply to reverse-Starker transactions.

The facts in this case establish that the transaction was a reverse-Starker transaction. Taxpayer closed on the purchase of Replacement Property on Date 1. Taxpayer sold Relinquished Property on Date 2. Taxpayer received Replacement Property on Date 1 because it was held on that date on Taxpayer's behalf by A as Taxpayer's agent or nominee. The evidence that A was holding Replacement Property on Taxpayer's behalf on Date 1 is compelling: Taxpayer negotiated the purchase; Taxpayer provided the funds; Taxpayer was personally liable on the purchase money mortgage while A was not; Taxpayer ordered that Replacement Property be titled to A. Therefore, Taxpayer received Replacement Property on Date 1, a date that was prior to the date on which Taxpayer transferred the Relinquished Property.

Since it is clear that Section 1.1031(k)-1 does not apply to a reverse-Starker transaction, none of the safe harbors contained in that section is available to avoid what would otherwise result from application of the normal rules of agency and constructive receipt. Absent the application of Section 1.1031(k)-1(g)(4)(i), which provides that a qualified intermediary is not considered the agent of the taxpayer, under the facts of this case the existence of an agency relationship is compelling. We conclude that A acquired title to Replacement Property in order to hold it on behalf of Taxpayer as an agent or nominee.

Taxpayer argues that we should apply the deferred exchange regulations to determine whether the transaction was or was not a reverse-Starker transaction. Specifically, under Section 1.1031(k)-1(g)(4)(i), Taxpayer argues that, by virtue of the arrangements between Taxpayer and A, A should be considered a qualified intermediary and thus not considered an agent of Taxpayer. This analysis would then compel a reversal of the actual order of events, with the result that Taxpayer would not be considered to have acquired Replacement Property prior to the date Taxpayer transferred Relinquished Property. Following this reasoning, the transaction would not constitute a reverse-Starker transaction.

We are not persuaded that Taxpayer should be able to bootstrap its arrangement into the scope of the safe harbor rules of Section 1.1031(k)-1 through such circuitous logic. Under the facts in this case, a written exchange agreement did not exist at the time A acquired title to Replacement Property. Therefore, A cannot satisfy the requirements for the qualified intermediary safe harbor because A did not acquire Replacement Property, as required by written agreement with Taxpayer, in accordance with paragraph (g)(4)(iii)(B) of Section 1.1031(k)-1. The previously cited language from the preamble to these regulations makes it abundantly clear that the provisions of Section 1.1031(k)-1 were made expressly inapplicable to a transaction such as this.

We conclude that the transaction does not constitute a deferred exchange within the scope of Section 1.1031(k)-1, but is instead a reverse-Starker transaction because Taxpayer first acquired Replacement Property through the agency of A before transferring Relinquished Property. Moreover, the circumstances surrounding the acquisition of Replacement Property and the subsequent transfer of Relinquished Property do not demonstrate the requisite interdependence to characterize the transaction as an exchange.

Where a taxpayer purchases property and sells property in separate transactions, the transactions ordinarily do not qualify as an exchange. A recent case in point is Lincoln v. Commissioner, T.C. Memo. 1998-421. In that case, the Tax Court held that a separate purchase and sale did not qualify as an exchange. The court noted that an exchange ordinarily requires a "reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only." Section 1.1002-1(d) of the regulations. In Lincoln, taxpayers purchased replacement property from its seller with a cash down payment and assumed a note for the balance. Almost a year later, taxpayers received an offer on their relinquished property, taxpayers sold the relinquished property and placed the proceeds in an escrow, controlled by taxpayers. The escrowed funds were used to repay taxpayers and to make improvements to the replacement property.

The Tax Court stated that, at most, the circumstances relating to taxpayers' establishment and use of the escrow account evidence their belated intent to avail themselves of Section 1031 treatment and the buyer's awareness of their intent. The circumstances do not, however, suggest any mutuality of intent between taxpayers and the buyer, much less between taxpayers and the seller, to effect an exchange. The court stated that it is well settled that a taxpayer's unilateral intent to undertake an exchange does not govern the tax consequences where no reciprocal transfer of property actually occurs.
In the facts of the instant case, there appears to be no evidence of mutuality of intent among Taxpayer, B, or S. S refused to complete an exchange and demanded settlement on the purchase of Replacement Property before Taxpayer could find a buyer for Relinquished Property. At the time of the purchase of Replacement Property there was no mutuality of intent with B for an exchange because B was not yet part of the transaction.

In Redwing Carriers, Inc. v. Tomlinson, 399 F. 2d 652 (5th Cir. 1968), the Service successfully argued that the taxpayer could not shape what was essentially an integrated purchase and trade-in transaction of new and used trucks into two separate transactions. The Fifth Circuit Court of Appeals agreed that the transactions constituted a like kind exchange, citing Rev. Rul. 61-119, 1961-1 C.B. 395. That ruling holds that where a taxpayer sells old equipment used in his trade or business to a dealer and purchases new equipment of like kind from the dealer under circumstances which indicate that the sale and the purchase are reciprocal and mutually dependent transactions, the sale and purchase is an exchange of property within the meaning of Section 1031 even though the sale and purchase are accomplished by separately executed contracts and are treated as unrelated transactions by the taxpayer and the dealer for record keeping purposes.

In Redwing Carriers, the sales price of the old equipment was increased by the "dealer's discount" on the new equipment, so that the sales price of the old equipment was dependent upon the purchase of the new equipment. The facts in this case do not show such interdependence. Taxpayer could have terminated the "exchange" transaction after the purchase of Replacement Property and could have kept Relinquished Property if, after the initial sale of Relinquished Property had fallen through, Taxpayer had found no satisfactory buyer.

Therefore, under these facts, the transaction was a separate noninterdependent purchase and sale, and does not qualify as an exchange. Accordingly, the transaction cannot qualify as a like kind exchange under Section 1031(a).

This document may not be used or cited as precedent.

INTERNAL REVENUE SERVICE INFORMATION LETTER 2007-0009

Internal Revenue Service (I.R.S.)
Information Letters
Issue: March 30, 2007
February 15, 2007

Section 1031 — Exchange of Property Held for Productive Use or Investment

The Honorable Bill Nelson
United States Senator
Landmark Two, 225 East Robinson Street
Suite 410
Orlando, FL 32801

Dear Senator Nelson:

I am responding to your inquiry, dated January 23, 2007, on behalf of ***. *** is engaging in a reverse like-kind exchange of real property, an exchange in which a taxpayer acquires replacement property and subsequently disposes of like-kind property ("relinquished property"). She has only a month remaining to sell the relinquished property to complete the exchange. She states that, given current conditions in Florida, she will probably not be able to make a timely sale. She requests relief from capital gains taxes when she sells the property to complete the exchange.

Generally, taxpayers must include in income all gain on the disposition of property. An exception to this general rule provides that taxpayers do not recognize gain or loss when they exchange property held for use in a trade or business or for investment for like-kind property to be held for such uses. (Section 1031(a)(1) of the of the Internal Revenue Code (the Code)). We have issued guidance which provides a safe -harbor assuring that taxpayers will qualify for nonrecognition of gain under section 1031(a)(1) of the Code if they complete a reverse like-kind exchange within 180 days and meet other requirements. (Revenue Procedure 2000-37, 2000-2 C.B. 308, modified by Rev. Proc. 2004-51, 2004-2 C.B. 294) I am enclosing copies of this guidance. In reverse exchanges, we can postpone the 180-day and other timeliness requirements of the safe-harbor in certain circumstances, such as a transaction affected by a Presidentially declared disaster. (Sections 7508 and 7508A of the Code). *** exchange does not seem to qualify for a postponement.

However, she may qualify to defer the gain on the disposition of the property she is trying to sell even if she does not complete the reverse exchange in the time set forth in the safe-harbor. She can do this by entering into a deferred like-kind exchange that meets certain requirements, including acquiring different like-kind replacement property by the earlier of 180th day after the date she transfers the relinquished property, or the due date of her tax return for the tax year that she transfers the relinquished property. I am enclosing a copy of Publication 544, Sales and Other Dispositions of Assets, which explains the rules applying to like-kind exchanges, including reverse like-kind exchanges and deferred like-kind exchanges.

I hope this information is helpful. If we can assist you further, please contact me or *** at ***.

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

PARTNERSHIP ISSUES

PARTNERSHIPS IN AN EXCHANGE (ARTICLE)

WHAT HAPPENS WHEN ONLY ONE PARTNER WANTS TO EXCHANGE?

A partnership may exchange property for other property of "like-kind." However, IRC Section 1031(a)(2)(D) specifically prohibits exchanges of partnership interests. This means that an Exchanger cannot buy into or sell interests in a partnership and qualify for a §1031 exchange. The rationale is that a partnership interest [along with a real estate investment trust (REIT) share] itself is personal property and thus is not "like-kind" with real property. Given these facts, what alternatives are available to Exchangers?

IS IT A 'TRUE' PARTNERSHIP?

First, investors owning a property together must determine if they really own the property in a true "partnership." Often, investors who own property with others may consider the other individuals their "partners" even though they hold title as an undivided interest and don't file a partnership tax return, thus they are merely "co-owners." The test is generally, "do the owners hold title as "tenants-in-common?"

POTENTIAL ALTERNATIVES

One option is that the entire partnership stays intact and exchanges the relinquished property for a replacement property. After the partnership closes on the replacement property, the property can be refinanced and the proceeds are distributed to the partner who wants to cash out.

Another alternative is that the partnership has a valid election out of subchapter K under IRC §761. The partner seeking to cash out sells their undivided interest and the other partner exchanges their tenancy-in-common interest for a replacement property. (Note: There are risks associated with partnership issues that must be discussed with a legal and/or tax advisor.)

ADDITIONAL CONSIDERATIONS

1. Advance planning is important, as the greater the period of time between the election out of the partnership and the exchange, the better. The election out of the partnership to the individuals as an undivided interest shortly before closing on the relinquished property leaves open the possibility that the exchange would be invalidated because the property was not held as an undivided interest long enough to be considered "held for investment." [Note: In several instances, however, the Tax Court has extended §1031 tax deferral to former partners who changed their ownership structure prior to closing on a relinquished property.]

2. If the entire partnership will be exchanging, it is preferable that the Partnership Agreement mention that they are holding the property "for investment or use in a trade or business."

3. Every Exchanger should always consult with their legal and/or tax advisors to review the many issues and risks involved with partnership situations. Contact Asset Preservation toll-free to discuss partnership issues in greater detail.

REVENUE RULING 2003-56

Internal Revenue Service (I.R.S.)
Revenue Ruling (Rev. Rul.)
Released: May 9, 2003
Correction Released: May 22, 2003
Published: June 9, 2003

Section 704 — Partner's Distributive Share, 26 CFR 1.704-2: Allocations attributable to nonrecourse liabilities

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under section 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnersh ip, and the relinquished liability and the replacement liability are nonrecourse liabilities, then under section 1.704- 2(d), is the partnership minimum gain on the last day of the first taxable year of the partnership computed by using the replacement property and the replacement nonrecourse liability?

Section 731 — Extent of Recognition of Gain or Loss on Distribution, 26 CFR 1.731-1: Extent of recognition of gain or loss on distribution.

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under section 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, and the liabilities netted for purposes of section 752, and if so, when is any net change in a partner's share of partnership liability taken into account?

Section 1031 — Exchange of Property Held for Productive Use or Investment, 26 CFR 1.1031(b)-1: Receipt of other property or money in tax-free exchange. 26 CFR 1.1031(k)-1: Treatment of deferred exchanges

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under Section 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, are the liabilities netted for purposes of Section 752, and if so, when is any net change in a partner's share of partnership liability taken into account?

Section 752 — Treatment of Certain Liabilities, 26 CFR 1.752-1: Treatment of certain liabilities

Like kind exchanges.

This ruling deals with the consequences under section 752 of the Code, and the minimum gain rules under section 1.704-2(d) of the regulations, of a section 1031 transaction that straddles two taxable years.

ISSUE

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under Section 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, are the liabilities netted for purposes of Section 752, and if so, when is any net change in a partner's share of partnership liability taken into account?

FACTS

Situation 1. P is a general partnership with two equal partners that reports on the calendar year. P owns Property 1, which has a fair market value of $300x and is subject to a liability of $100x. P has an adjusted basis of $80x in Property 1. P enters into an agreement for a deferred like kind exchange of properties that qualifies under Section 1031(a)(1). Pursuant to the agreement, P transfers Property 1 on October 16, Year 1, subject to the liability. On January 17, Year 2, P receives Property 2, which has a fair market value of $260xxx, subject to a liability of $60x. Thus, P has a net decrease in liability of $40x.

Situation 2. Situation 2 is the same as Situation 1 except that Property 2 has a fair market value of $340x and is subject to a liability of $140x. Thus, P has a net increase in liability of $40x.

LAW

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of partnership liabilities, shall be considered as a contribution of money by the partner to the partnership.
Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of the individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 1031(a)(1) 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 that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(3) provides that any property received by a taxpayer will be treated as property which is 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 (including extensions) for the taxpayer's federal income tax return for the taxable year in which the transfer of the relinquished property occurs.

Section 1031(b) provides that if an exchange would be within the provisions of Section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by the provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of the money and the fair market value of the other property.

Section 1.1031(b)-1(c) of the Income Tax Regulations provides that consideration in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of Section 1031(b). Where, in an exchange described in Section 1031(b), each party either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money, consideration given in the form of an assumption of liabilities (or the receipt of property subject to a liability) is offset against consideration received in the form of an assumption of liability (or transfer subject to a liability).

Example (5) of Section 1.1031(k)-1(j)(3), describes the following situation: B has an adjusted basis in real property X of $40,000. On May 17, 1991, B transfers real property X, which is encumbered by a mortgage of $30,000 and has a fair market value of $100,000, to C with C assuming the $30,000 mortgage on real property X. On July 5, 1991, C transfers real property V, which is encumbered by a $20,000 mortgage and has a fair market value of $90,000, to B with B assuming the mortgage. The consideration received by B in the form of the liability assumed by C ($30,000) is offset by the consideration given by B in the form of the liability assumed by B ($20,000), and the net amount, $10,000, is treated as "money or other property." Thus, B recognizes gain under Section 1031(b) in the amount of $10,000.

Rev. Rul. 94-4, 1994-1 C.B. 196, holds that a deemed distribution of money under Section 752(b) resulting from a decrease in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money under Section 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership taxable year. An amount treated as an advance or drawing of money is taken into account at the end of the partnership taxable year.

Section 1.704-2(d)(1) provides that the amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year.

ANALYSIS

If a partnership enters into a Section 1031 exchange, consideration given in the form of the receipt of the replacement property subject to a liability (replacement liability) is offset against consideration received in the form of the transfer of the relinquished property subject to a liability (relinquished liability) in determining the amount of money or other property for purposes of Section 1031(b) (hereinafter referred to simply as "money or other property") received in the exchange that is used to calculate gain recognized under Section 1031(b). Section 1.1031(b)-1(c). If the exchange straddles two taxable years of the partnership, the amount of the relinquished liability that exceeds the amount of the replacement liability is treated as money or other property received in the first taxable year of the partnership, since the excess is attributable to the transfer of the relinquished property subject to the relinquished liability in that year. In addition, any gain resulting from the receipt of money or other property in the first taxable year of the partnership must be recognized and reported in that year.

The liability offsetting rule of Section 1.1031(b)-1(c) also is taken into account for purposes of determining the amount of any decrease in a partner's share of partnership liability under Section 752(b), which is treated as a deemed distribution of money to the partner. Accordingly, if a partnership enters into a Section 1031 exchange that straddles two taxable years of the partnership, each partner's share of the relinquished liability is offset with each partner's share of the replacement liability for purposes of determining any decrease in a partner's share of partnership liability under Section 752(b). Any net decrease is taken into account in the first taxable year of the partnership since it is attributable to the transfer of the relinquished property subject to the relinquished liability in that year.

Any deemed distribution of money to the partners under Section 752(b) in the first taxable year of the partnership is treated as an advance or drawing of money to the extent of each partner's distributive share of partnership income for that year. Rev. Rul. 94-4. For this purpose, any gain recognized by the partnership under Section 1031(b) from the net decrease in liability resulting from the exchange is included in the partners' distributive share of partnership income for the first taxable year of the partnership. An amount treated as an advance or drawing of money is taken into account by the partners at the end of that year.

In addition, if a partner's share of the replacement liability exceeds the partner's share of the relinquished liability, only the net increase in liability is taken into account for purposes of determining the increase in the partner's share of partnership liability under Section 752(a). The net increase is taken into account in the second taxable year of the partnership since it is attributable to the receipt of the replacement property subject to the replacement liability in that year.

Furthermore, if the relinquished liability and the replacement liability are nonrecourse liabilities, then under Section 1.704-2(d), the partnership minimum gain on the last day of the first taxable year of the partnership is computed by using the replacement property and the replacement nonrecourse liability.

In Situation 1, P's amount realized is $300x (the fair market value of the replacement property ($260x), increased by the relinquished liability ($100x), and decreased by the replacement liability ($60x)), and P's adjusted basis in the relinquished property is $80x, resulting in a realized gain of $220x. Under Section 1031(b), P recognizes gain only to the extent of money or other property received in the exchange. The relinquished liability of $100x is offset by the replacement liability of $60x in determining the amount of money or other property that P is treated as receiving. Therefore, under Section 1031(b), P is treated as receiving $40x of money or other property and therefore recognizes a gain of $40x in Year 1. That gain is allocated $20x to each partner of P as part of each partner's distributive share of P's Year 1 income. Furthermore, under Section 752(b), each partner is treated as receiving a deemed distribution from the partnership of $20x in Year 1. Under Rev. Rul. 94-4, each partner's Section 752(b) deemed distribution of $20x is treated as an advance or drawing of money to the extent of each partner's distributive share of P's income for Year 1.

In Situation 2, P's amount realized is $300x (the fair market value of the replacement property ($340x), increased by the relinquished liability ($100x), and decreased by the replacement liability ($140x)), and P's adjusted basis in the relinquished property is $80x, resulting in a realized gain of $220x. Under Section 1031(b), P recognizes gain only to the extent of money or other property received in the exchange. The relinquished liability of $100x is offset by the replacement liability of $140x in determining the amount of money or other property that P is treated as receiving. Therefore, under Section 1031(b), P is not treated as having received money or other property. Accordingly, P recognizes no gain in Year 1. Furthermore, under Section 752(a), each partner is treated as having made a contribution to the partnership of $20xx in Year 2.

HOLDING

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under Section 1031 in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, the liabilities are netted for purposes of Section 752. Any net decrease in a partner's share of partnership liability is taken into account for purposes of Section 752(b) in the first taxable year of the partnership, and any net increase in a partner's share of partnership liability is taken into account for purposes of Section 752(a) in the second taxable year of the partnership.

DRAFTING INFORMATION

The principal author of this revenue ruling is Pietro Canestrelli of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For more information regarding this revenue ruling, contact Mr. Canestrelli at (202) 622-3060 (not a toll-free call).

REVENUE RULING 78-135

Internal Revenue Service (I.R.S.)
Revenue Ruling (Rev. Rul.)
Published: 1978

LIKE-KIND EXCHANGE; PARTNERSHIP INTERESTS

26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment.

(Also Section 741; 1.741-1.)

Like-kind exchange; partnership interests. Gain or loss realized on an exchange of general partnership interests does not qualify for nonrecognition under section 1031(a) of the Code.

Advice has been requested whether, under the circumstances described below, gain or loss realized on the exchange of partnership interests qualifies for nonrecognition under section 1031(a) of the Internal Revenue Code of 1954.

A owned a 10 percent general partnership interest in partnership X and a 15 percent general partnership interest in partnership Y. B owned a 15 percent general partnership interest in partnership X and a 10 percent general partnership interest in partnership Y. A and B entered into an agreement whereby A conveyed A's interest in partnership X to B in exchange for B's interest in partnership Y.

Section 1031(a) of the Code provides that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

The language in the parenthetical clause of section 1031(a) of the Code in part encompasses all types of equity interests in financial enterprises other than by direct ownership of the underlying property. Because a partnership interest represents such an equity interest, it comes within the ambit of the parenthetical clause of section 1031(a).

Moreover, section 741 of the Code provides, in part, that in the case of a sale or exchange of an interest in a partnership gain or loss shall be recognized to the transferor partner. Thus, section 741, which requires recognition of gain or loss, is in conformity with the parenthetical clause of section 1031(a), which excepts exchanges of equity interests in financial enterprises from nonrecognition under section 1031.

In the instant case, both A and B have transferred property of a type that is described in the parenthetical clause of section 1031(a) of the Code. Accordingly, any gain or loss realized by A and B on the exchange of such property does not qualify for nonrecognition under section 1031(a).

The holding in this revenue ruling is consistent with the Service's nonacquiescence in Estate of Rollin E. Meyer, 58 T.C. 311 (1972), nonacq., 1975-1 C.B. 3, aff'd per curiam, 503 F.2d 556 (9th Cir. 1974).

CHIEF COUNSEL ADVISORY 200650014

Internal Revenue Service (I.R.S.)
Chief Counsel Advisory (CCA)
Issue: December 15, 2006
September 7, 2006

Section 701 — Partners, Not Partnerships, Subject to Tax
Section 732 — Basis of Distributed Property Other Than Money

To: Kelly Davidson, Attorney Advisor John Duncan, Attorney Advisor Large & Mid-Size Business
From: Christine Ellison, Chief, Branch 3 (Passthroughs & Special Industries)
Subject: Application of Sections 731 and 732 to property acquired by a partnership solely for purposes of distribution in liquidation to a retiring partner

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND
Partnership =
Taxpayer =
LLC =
State X =
State Y =
$a =
$b =
$c =
$d =
$e =
$f =
$g =
$h =
$i =
$j =
z =
Date 1 =
Date 2 =
Year 1 =
Year 2 =
A =
B =

ISSUE

Whether a distribution purportedly in redemption of Taxpayer's interest in Partnership included the State Y house purchased by Partnership.
CONCLUSION

The non-recognition provision of Â§ 731 and substituted basis rule of Â§ 732(b) do not apply when a partnership acquires residential real estate that has no relation to a partnership's business activities, solely for purposes of immediately distributing the real estate to a partner in liquidation.

FACTS

Partnership owned a large parcel of *** (parcel) in State X. Partnership was also an obligor on several promissory notes secured by deeds of trust encumbering certain portions of Partnership's parcel.

Taxpayer held a total of z percent interest in Partnership directly and indirectly through various trusts. The majority of the partnership interests were held by members of Taxpayer's family and related entities.

Due to ongoing disagreements among the partners, most of the partners (the exiting partners) in Partnership, including Taxpayer, liquidated their interests in Partnership leaving A and A's immediate family (the remaining partners) in control of Partnership. The remaining partners' interests in Partnership increased proportionately as a result of the liquidation of the exiting partners' interests.

The liquidation of Taxpayer's partnership interest was specifically outlined in a redemption agreement. The redemption agreement provided for the purchase and distribution in redemption to Taxpayer of a house in State Y. Specifically, the redemption agreement provided:

All amounts paid in excess of $a to acquire the [State Y house] as set forth in the Final Closing Statement for the acquisition of the [State Y house] are referred to herein as the "Excess Amount." [Taxpayer] shall be responsible to take out a new loan against the [State Y house] sufficient in amount to repay [Partnership] the Excess Amount (the "New Loan"). [Partnership] and [Taxpayer] acknowledge and agree to treat the distribution of the Real

Property to [Taxpayer] by the nominee of [Partnership] hereunder as a distribution of property other than cash by a partnership to a partner pursuant to I.R.C. Section 731. [Partnership] shall nominate [LLC], a [State Y] limited liability company that is wholly owned by [Partnership] and treated as a disregarded entity under Treas. Reg. Section 301.7701-3 (the "Nominated Purchaser"). [Taxpayer] shall pay all costs and expenses associated with the formation of the Nominated Purchaser. The Nominated Purchaser shall acquire the [State Y house] at the First Closing on behalf of [Partnership]. The Nominated Purchaser on behalf of [Partnership] shall distribute the [State Y house] to [Taxpayer] upon funding of the New Loan within sixty (60) days after the First Closing ("Extension Period") conditioned upon the Nominated Purchaser receiving the Excess Amount plus all other costs associated with the ownership of the [State Y house] by the Nominated Purchaser including all costs of property and casualty insurance and general liability insurance, in such amount and from an insurance company reasonably approved by [Partnership]. It is the intent of the parties that Nominated Purchaser not be responsible for greater than $a in connection with the purchase, ownership, and subsequent transfer of the [State Y house] to [Taxpayer]. [Taxpayer] shall not have any rights to possession of the [State Y house] until the [State Y house] has been distributed by the Nominated Purchaser in accordance with this Section. If for any reason the New Loan does not close within the Extension Period, [Taxpayer] will forfeit all rights to receive the [State Y house], and in lieu of agrees as follows: The Nominated Purchaser shall sell the [State Y house] as soon as reasonably possible after the end of the Extension Period. Upon sale, the net proceeds and costs related thereto shall be allocated and disbursed as follows: [B] Loan plus accrued interest will be paid in full directly from the sale escrow. [Partnership] and the Nominated Purchaser shall retain $b from the sale escrow as liquidated damages, and [B] shall receive $b as additional contingent interest on the [B] Loan. The net proceeds from the sale of the [State Y house] will be paid to [Taxpayer] by the Nominated Purchaser on behalf of [Partnership] for the redemption of the [Taxpayer] Partnership Interest. ...

To transfer the State Y house to Taxpayer, the following occurred. First, Partnership formed an LLC. Next, on Date 1, Year 1, the LLC purchased the State Y house for $c. The consideration that LLC used to purchase the State Y house consisted of $d cash loaned by B, a partner who was also to be redeemed under the redemption agreement, and $j cash of LLC or Partnership. Pursuant to the terms of the redemption agreement, in Date 2 of Year 2, Taxpayer took out a $e mortgage against the State Y house and used the proceeds to pay LLC. LLC then repaid B. Simultaneously, LLC transferred the State Y house to Taxpayer by grant deed.

Taxpayer recognized $f in income on account of the money received in excess of Taxpayer's basis in Partnership. This amount consists of $g I.R.C. Section 752(b) debt relief deemed distribution, $h total cash payments distributed on Date 2, Year 2, and $i in later distributions. Taxpayer claims that the total distribution of money does not include the fair market value of the State Y house because, under and *** Section 1.731-1(a)(1)(i), in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Taxpayer claims that, under I.R.C. Section 732(b) and Section 1.732-1(b), if a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of the partner's interest in the partnership reduced by the amount of any money distributed to the partner in the same transaction. Taxpayer's basis in the partnership interest was zero as of Date 2, Year 2, and Taxpayer claims a zero basis in the State Y house.

LAW AND ANALYSIS

Section 731 provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and that any gain so recognized shall be considered as gain from the sale or exchange of the partnership interest of the distributee partner.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(a) Distribution not a distribution of partnership property

The Internal Revenue Code of 1954 adopted comprehensive partnership tax rules in subchapter K. In the legislative history to the provisions relating to contributions and distributions, the Ways and Means Committee of the House of Representatives explained the carry-over basis rules of Sections 721 and 731:

The proposed rules for contributions to, and distributions by, a partnership, in effect, permit the tax-free transfer of property into or out of a partnership. Generally, speaking, the basis of property remains unchanged through the formation and dissolution of a partnership. This relatively simple approach is made possible by reducing the basis of the distributee's interest in the partnership by the basis of the distributed partnership property and by the recognition of gain or loss in the case of certain distributions. H. Rep. No. 1337, at 69 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4096. (Emphasis added).

Similarly, the Senate Finance Committee explained:

These new distribution rules limit quite narrowly the area in which gain or loss is recognized upon a distribution. Gain is to be recognized only where the money distributed is in excess of a partner's basis for his interest; and loss is to be recognized in the case of a liquidating distribution where only money, inventory items and unrealized receivables are distributed and their basis to the partnership is less than the basis of the partner's interest. These rules, combined with the nonrecognition of gain or loss upon contribution of property to a partnership, will remove deterrents to property being moved in and out of partnerships as business reasons dictate. S. Rep. No. 1622, at 96 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4729. (Emphasis added).

Under the facts presented in this case, a carry-over basis is not appropriate for a unique parcel of residential property that apparently was selected by the distributee, acquired by the partnership immediately before the distribution, solely for the purpose of the distribution, and was unrelated to the partnership's business activities.

Moreover, the facts are consistent with a finding that Partnership was never the owner of the State Y house for federal tax purposes. A significant portion of the purchase price for the State Y house was provided by funds borrowed from Taxpayer's relative (relative), a loan that was immediately repaid by Taxpayer. The redemption agreement provided that, if Taxpayer did not pay all of the expenses associated with the transaction and repay Partnership the amount of the purchase price in excess of $a within a stated period of time, the State Y house would be sold, Partnership reimbursed for expenses and provided an amount in liquidated damages, the relative lender repaid, and the remaining funds distributed to Taxpayer.

The facts in this case are consistent with a finding that the State Y house was acquired and held for the account of Taxpayer and became property of the Taxpayer at the time it was acquired for Taxpayer by the Partnership. See Rev. Rul. 55-39, 1955-1 C.B. 403 (investment by partnership of partner's contributed capital in securities of partner's choice and for partner's own account constituted a withdrawal of capital from the partnership and an investment by partner in securities purchased, resulting in reduction in partner's partnership interest). When Partnership purchased the State Y house for Taxpayer, it in effect distributed cash to Taxpayer in the amount of the $a, the amount used by Partnership to acquire the State Y house. The subsequent purported distribution of the State Y house to Partner is not a distribution of partnership property under Section 731. See id.

We conclude that Sections 731 and 732 do not apply to the purported distribution of the State Y house to Taxpayer because the distribution was not a distribution of Partnership property.

(b) Partnership Anti-Abuse Rules

Alternatively, if the State Y house was properly considered to be property of Partnership, the transaction should be recast in accordance with the regulations under Section 1.701-2 (the anti-abuse rules). The anti-abuse rules provide that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes. Section 1.701-2(b).

Section 1.701-2(a) provides that the following requirements are implicit in the intent of subchapter K: (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) The form of each partnership transaction must be respected under substance over form principles; and (3) Except as otherwise provided in paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income).

Section 1.701-2(c) describes certain of the factors that may be taken into account in determining whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Three of those factors are: (i) the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly, (ii) the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction, and (iii) substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another.

With respect to these three factors, if the Taxpayer purchased the State Y house directly, Taxpayer's tax liability would have been greater as Taxpayer would have to recognize an additional $a of income or gain. In addition, through the use of the subchapter K rules, Taxpayer's tax liability is substantially less than would have been the case if the steps of the transaction were integrated to treat Taxpayer as receiving a distribution of $a cash from Partnership, and then purchasing the State Y house. Furthermore, all of the partners in Partnership are related (directly or indirectly) to one another.

To liquidate Taxpayer's interest in Partnership, Partnership made a purported distribution to Taxpayer of the fair market value of the State Y house (in addition to $g debt relief and $h total cash payments) to Taxpayer for the value of Taxpayer's interests in Partnership. Because this exceeded Taxpayer's basis in Partnership, Taxpayer would have had to recognize an additional $a of income or gain if paid directly to Taxpayer. By attempting to characterize the distribution of the fair market value of the State Y house as a distribution of property other than money, Taxpayer and Partnership used the rules of subchapter K inappropriately in a manner that attempted to eliminate $a of income or gain with respect to Taxpayer.

We conclude that the transaction should be recast in accordance with the anti-abuse rules of Section 1.701-2 as a distribution of $a in cash to Taxpayer, which Taxpayer then used, in addition to funds provided directly (albeit temporarily) by B, to acquire the State Y house.

(c) Step Transaction and Economic Substance

Finally, this transaction may be attacked under judicial doctrines of step transaction and a lack of economic substance.

A transaction may be recast to reflect its true nature under the step transaction doctrine. Andantech LLC v. Comm'r, T.C. Memo. 202-07, aff'd in part and remanded in part, 331 F.3d 975 (D.C. Cir. 2003); True v. U.S., 190 F.3d 1165, 1176-77 (10th Cir. 1999). Under the step transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for "no other purpose than to avoid tax." Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 213-214 (D.C. Cir. 2001), cert. Denied, 534 U.S. 1104 (2002). As described in Smith v. Comm'r, 78 T.C. 350, 389 (1982), aff'd without op., 820 F.3d 1220 (4th Cir. 1987):
The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. See Gregory v. Helvering, 293 U.S. 465 (1935).

The existence of business purposes and economic effects for the individual steps in a complex series of transactions does not preclude application of the step transaction doctrine. True, supra.

There are three alternative tests for deciding whether the step transaction doctrine applies in a particular situation, namely: (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step(s) ("binding commitment test"), (2) if separate steps constitute prearranged parts of a single transaction intended to reach an end result ("end result test"), or (3) if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps ("interdependence test"). See Associated Wholesale Grocers, Inc. v. Comm'r, 927 F.2d 1517 (10th Cir. 1991).

Each step taken by the parties (the formation of the LLC, the loan to purchase the house, the purchase of the house, and the subsequent transfer of the house to Taxpayer upon liquidation of her partnership interest) were mere transitory steps toward the ultimate goal of transferring $a of value to Taxpayer in the form of a personal residence, without gain recognition. The individual steps were prearranged in a binding contract and had no independent business purpose. Under step transaction principles, the acquisition of the State Y house by Partnership and its distribution to Taxpayer should be disregarded.

Moreover, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction in order to be respected for federal tax purposes. See Gregory v. Helvering, 293 U.S. 465 (1935). If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Comm'r, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Comm'r, 87 T.C. 1087 (1986); Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); ACM Partnership v. Comm'r, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). In determining whether a transaction has economic substance, both the objective economic substance of the transaction and the subjective business motivation of the taxpayer must be determined. The objective economic substance of the transaction and the involved parties' subjective business motivations must be determined. ACM Partnership v. Comm'r, 157 F.3d 231, 247 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999); Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction has sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

The objective standard is whether a transaction has any practical economic effects aside from the creation of tax losses and/or the transaction was devoid of economic substance because it did not appreciably affect the taxpayer's non-tax beneficial interest. ACM Partnership, 157 F.3d at 247. Offsetting legal obligations or circular cash flows may effectively eliminate any real economic significance of a transaction. Knetsch v. United States, 364 U.S. 361 (1960).

To analyze a transaction's economic aspects, courts look to whether the taxpayer had a non-tax business purpose for the transaction and a reasonable expectation of profit. See ACM Partnership, 157 F.3d at 252-54; see also Coltec Industries v. United States, ___ F.3d___No. 05-5111 (Fed. Cir. July 2006) and Black & Decker v. U.S., 436 F.3d 431 (4th Cir. 2006) (focus is on the transaction creating tax benefits not overall business purpose of taxpayer). The determination turns on whether the transaction is rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it are to be evaluated in accord with commercial practices in the relevant industry. Cherin v. Comm'r, 89 T.C. 986, 993-94 (1987). A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs. Yosha v. Comm'r, 861 F.3d 494, 498-99 (7th Cir. 1988).

Objectively, Partnership's purchase of the State Y house and immediate distribution to Taxpayer had no practical economic effects aside from the avoidance of gain recognition. The acquisition of the State Y house was structured to avoid any potential gain or loss by Partnership on the transaction. Taxpayer was apparently entitled to $a of value from Partnership and received $a of value. The use of a residential property acquired solely for the purpose of avoiding gain recognition on that $a of value had no objective economic effect.

Subjectively, Partnership and Taxpayer clearly had no intent to profit economically from the transaction. It is evident from the terms of the redemption agreement that the State Y house was to be distributed by LLC.to Taxpayer immediately upon Taxpayer obtaining a loan (within 60 days) to fund the purchase. In addition, LLC would be reimbursed all costs and expenses associated with the purchase of the State Y house. If Taxpayer could not obtain the necessary loan within 60 days, LLC would immediately sell the State Y house. It is difficult to conclude an intent to profit from the purchase and sale of a house within a brief 60 day period. Clearly, the sole purpose of the transaction was to obtain tax benefits that would not be available otherwise.

We conclude that under step transaction principles, the acquisition of the State Y house by Partnership and its distribution to Taxpayer should be disregarded. We also conclude that the acquisition of the State Y house by Partnership and the distribution of the house to Taxpayer lacked economic substance and are unnecessary steps taken solely to achieve tax benefits.

PERSONAL PROPERTY EXCHANGES

PERSONAL PROPERTY EXCHANGES (ARTICLE)

"PLANES, TRAINS AND AUTOMOBILES"

Internal Revenue Code Section 1031 allows investors to exchange either "like-kind" real or personal property for other "like-kind" real or personal property. Although the rules for "like-kind" real estate are fairly broad, the rules to exchange personal property for "like-kind" or "like-class" specify that an Exchanger can only receive tax deferral if the sale of personal property is exchanged for the purchase of personal property that falls within the same Product Class or General Asset Class. Product and General Asset Classes, as described in the North American Industry Classification System (NAICS), were developed for use in the classification of establishments and products by the type of activity for which they are engaged. Depreciable tangible personal property is exchanged for property of "like-kind" if it is exchanged for property of "like-class".

GENERAL ASSET CLASSES

(1) Office furniture, fixtures, and equipment;

(2) Information systems (computers);

(3) Data handling equipment, except computers;

(4) Airplanes and helicopters;

(5) Automobiles and taxis;
(6) Buses;

(7) Light general-purpose trucks;

(8) Heavy general-purpose trucks;

(9) Railroad cars and locomotives;

(10) Tractor units for use over-the-road;

(11) Trailers and trailer-mounted containers;

(12) Vessels, barges, tugs, and similar water transportation equipment;

(13) Industrial steam and electric generation and distribution systems.

UNEXCHANGEABLE ITEMS

Another aspect of personal property exchanges that differs from real property exchanges is that certain items of the sale transaction, such as "goodwill" "covenants not to compete" and "inventory" do not qualify for tax deferral under IRC Section 1031. Thus, these items may not be attributed to the value of the sale for the exchange and the capital gain or loss must be recognized by the Exchanger.

MIXED EXCHANGES

There are also many transactions that involve the sale of both real property and personal property, such as the sale of hotels, restaurants, and gas stations, wherein the Exchanger owns both the land and the personal property. In this case, the Exchanger can allocate the proceeds specifically for real property and personal property and purchase "like-kind" property with the respective funds. In a complex combined real and personal property exchange, it is important to maximize potential tax deferral benefits in advance. Asset Preservation, Inc. encourages Exchangers to always work closely with an accountant or attorney to ensure that the transaction is structured properly.

REVENUE RULING 89-121

Internal Revenue Service
Revenue Ruling
EXCHANGE OF SIMILAR BUSINESSES UNDER SECTION 1031 OF THE CODE
Published: November 3, 1989

Section 1031. - Exchange of Property Held for Productive Use or Investment, 26 CFR 1.103(a)-1: Property held for productive use in trade or business or for investment.

Exchange of similar businesses under section 1031 of the Code. The transfer of the assets of a business in exchange for the assets of a similar business cannot be treated as an exchange of a single property under section 1031 of the Code. Rev. Ruls. 57-365 and 85-135 clarified.

ISSUE

Should the exchange of the assets of a business for the assets of a similar business be treated as an exchange of a single property for another single property in applying the provisions of section 1031 of the Internal Revenue Code?

FACTS

The facts are the same as those set forth in Rev. Rul. 85-135, 1985-2 C.B. 181. Rev. Rul. 85-135 concerns the application of sections 1031, 1033, and 1071 of the Code to the exchange of the assets of television stations. Under the facts of that revenue ruling, X corporation owned television stations K and L. Y corporation owned television station H. To diversify their media markets and to comply with the Federal Communications Commission's cross-ownership policies, X exchanged with Y the assets of K and L for the assets of H. The assets exchanged did not include property described in section 1031(a)(2) of the Code (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, choses in action, interests in a partnership, certificates of trust or beneficial interest, other securities, or evidences of indebtedness or interest).

LAW AND ANALYSIS

Section 1031(a) of the Code provides that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment (with certain exceptions not relevant here) is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

Rev. Rul. 85-135 holds, in part, that X and Y each received property of a like kind to that transferred so that both X and Y qualify for nonrecognition of gain or loss on the exchange pursuant to section 1031(a) of the Code. In so holding, Rev. Rul. 85-135 fails to address the manner in which like-kind property is determined in the exchange. In Rev. Rul. 72-151, 1972-1 C.B. 225, the Service held that, when an exchange involves multiple assets, the fact that the assets in the aggregate comprise a business or an integrated economic investment does not cause the exchange to be treated as a disposition of a single property for purposes of section 1031. Rather, an analysis is required of the underlying assets involved in the exchange. See Rev. Rul. 55-79, 1955-1 C.B. 370.

HOLDING

X's transfer of the assets of K and L in exchange for Y's transfer of the assets of H cannot be treated as an exchange of a single property for another single property in applying the provisions of section 1031 of the Code. Rather, the determination of whether (or the extent to which) section 1031 applies to an exchange of the assets of one business for the assets of another business requires an analysis of the underlying assets exchanged.

EFFECT ON OTHER REVENUE RULINGS

This revenue ruling clarifies Rev. Rul. 85-135 regarding the determination of like-kind property in an exchange of multiple assets under section 1031 of the Code. This revenue ruling similarly clarifies Rev. Rul. 57- 365, 1957-2 C.B. 521, which involves the exchange of the assets of one telephone company for the similar assets of another telephone company, and holds that the exchange of the assets of one business for identical assets of another will be considered an exchange of property of a like kind within the scope of section 1031 of the Code.

DRAFTING INFORMATION

The principal author of this revenue ruling is Christopher Rogers of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Rogers on (202) 377- 9583 (not a toll-free call).

REVENUE RULING 85-135

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: November 3, 1989

Section 1.1031 — Property Held for Productive Use In Trade or Business or for Investment

26 CFR 1.1031(a)-1

EXCHANGE OF SIMILAR BUSINESSES UNDER SECTION 1031 OF THE CODE

Exchange of similar businesses under section 1031 of the Code. The transfer of the assets of a business in exchange for the assets of a similar business cannot be treated as an exchange of a single property under section 1031 of the Code. Rev. Ruls. 57-365 and 85-135 clarified.

ISSUE

Should the exchange of the assets of a business for the assets of a similar business be treated as an exchange of a single property for another single property in applying the provisions of Section 1031 of the Internal Revenue Code?

FACTS

The facts are the same as those set forth in Rev. Rul. 85-135, 1985-2 C.B. 181. Rev. Rul. 85-135 concerns the application of sections 1031, 1033, and 1071 of the Code to the exchange of the assets of television stations. Under the facts of that revenue ruling, X corporation owned television stations K and L. Y corporation owned television station H. To diversify their media markets and to comply with the Federal Communications Commission's cross-ownership policies, X exchanged with Y the assets of K and L for the assets of H. The assets exchanged did not include property described in section 1031(a)(2) of the Code (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, choses in action, interests in a partnership, certificates of trust or beneficial interest, other securities, or evidences of indebtedness or interest).

LAW AND ANALYSIS

Section 1031(a) of the Code provides that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment (with certain exceptions not relevant here) is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

Rev. Rul. 85-135 holds, in part, that X and Y each received property of a like kind to that transferred so that both X and Y qualify for nonrecognition of gain or loss on the exchange pursuant to section 1031(a) of the Code. In so holding, Rev. Rul. 85-135 fails to address the manner in which like-kind property is determined in the exchange. In Rev. Rul. 72-151, 1972-1 C.B. 225, the Service held that, when an exchange involves multiple assets, the fact that the assets in the aggregate comprise a business or an integrated economic investment does not cause the exchange to be treated as a disposition of a single property for purposes of section 1031. Rather, an analysis is required of the underlying assets involved in the exchange. See Rev. Rul. 55-79, 1955-1 C.B. 370.

HOLDING

X's transfer of the assets of K and L in exchange for Y's transfer of the assets of H cannot be treated as an exchange of a single property for another single property in applying the provisions of section 1031 of the Code. Rather, the determination of whether (or the extent to which) section 1031 applies to an exchange of the assets of one business for the assets of another business requires an analysis of the underlying assets exchanged.

EFFECT ON OTHER REVENUE RULINGS

This revenue ruling clarifies Rev. Rul. 85-135 regarding the determination of like-kind property in an exchange of multiple assets under section 1031 of the Code. This revenue ruling similarly clarifies Rev. Rul. 57-365, 1957-2 C.B. 521, which involves the exchange of the assets of one telephone company for the similar assets of another telephone company, and holds that the exchange of the assets of one business for identical assets of another will be considered an exchange of property of a like kind within the scope of section 1031 of the Code.

DRAFTING INFORMATION

The principal author of this revenue ruling is Christopher Rogers of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Rogers on (202) 377-9583 (not a toll-free call).

REVENUE RULING 82-166

Internal Revenue Service (I.R.S.)
Revenue Ruling (Rev. Rul.)
Published: October 4, 1982

SALES OR EXCHANGES; LIKE KIND; GOLD BULLION FOR SILVER BULLION

Section 1031 — Exchange of Property for Productive Use or Investment, 26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment.

Sales or exchanges; like kind; gold bullion for silver bullion. The exchange of gold bullion held for investment for silver bullion held for investment does not qualify for nonrecognition of gain as an exchange of like kind property under section 1031(a) of the Code.

ISSUE

Does an exchange of gold bullion held for investment for silver bullion held for investment qualify for nonrecognition of gain under section 1031(a) of the Internal Revenue Code?

FACTS

An individual taxpayer, who is not a dealer in gold or silver bullion, purchased gold bullion in the cash market and held it as an investment. In 1980, after the gold bullion had appreciated in value, the taxpayer exchanged the gold bullion for silver bullion of equal total fair market value. A gain was realized by the taxpayer as a result of the exchange. The taxpayer holds the silver bullion as an investment.

LAW AND ANALYSIS

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

Section 1.1031(a)-1(b) of the Income Tax Regulations provides that as used in section 1031(a) of the Code, the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class.

Rev. Rul. 79-143, 1979-1 C.B. 264, holds that the exchange of United States $20 gold coins (numismatic-type coins) for South African Krugerrand gold coins (bullion-type coins) does not qualify for nonrecognition of gain under section 1031(a) of the Code because the numismatic-type coins and the bullion-type coins represent totally different types of underlying investment and thus are not property of like kind. The bullion-type gold coins, unlike the numismatic-type gold coins, represent an investment in gold on world markets rather than in the coins themselves.

In this case, the values of the silver bullion and the gold bullion are determined solely on the basis of their metal content. Although the metals have some similar qualities and uses, silver and gold are instrinsically different metals and primarily are used in different ways. Silver is essentially an industrial commodity. Gold is primarily utilized as an investment in itself. An investment in one of the metals is fundamentally different from an investment in the other metal. Therefore, the silver bullion and the gold bullion are not property of like kind.

HOLDING

The taxpayer's exchange of gold bullion for silver bullion does not qualify for nonrecognition of gain under section 1031(a) of the Code.

REVENUE RULING 82-96

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: May 17, 1982

Section 1031 — Exchange of Property Held for Productive Use or Investment

Sales or exchanges; like kind; gold bullion for gold coins. The exchange of gold bullion for Canadian Maple Leaf gold coins qualifies for nonrecognition of gain or loss as a like kind exchange under section 1031(a) of the Code.

ISSUE

Does the exchange of gold bullion for Canadian Maple Leaf gold coins qualify for nonrecognition of gain or loss under section 1031 of the Internal Revenue Code?

FACTS

In individual taxpayer, who is not a dealer in gold bullion or coins, purchased gold bullion in the cash market and held it as an investment. The taxpayer subsequently exchanged the gold bullion for Canadian Maple Leaf gold coins, which also were held for investment. On the date of the exchange, the total fair market value of the gold bullion was equal to the total fair market value of the Canadian Maple Leaf gold coins.

The Canadian Maple Leaf gold coin is legal tender in Canada. However, the gold content of each coin greatly exceeds its face amount of $50. The Canadian Maple Leaf gold coin has no numismatic value.

LAW AND ANALYSIS

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

Section 1.1031(a)-1(b) of the Income Tax Regulations provides that as used in section 1031(a) of the Code, the words 'like kind' have reference to the nature or character of the property and not its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class.

Section 1031(b) of the Code provides that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without recognition of gain, but also of other property or money, then the gain, if any, to the recipient will be recognized, but in an amount not in excess of the sum of the money and the fair market value of the other property.

Section 1031(c) of the Code provides that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without recognition of gain or loss, but also of other property or money, then no loss from the exchange will be recognized.

In Rev. Rul. 74-218, 1974-1 C.B. 202, currency, in its usual and ordinary acceptation, is defined as gold, silver, other metals, or paper used as a circulating medium of exchange.

Rev. Rul. 76-214, 1976-1 C.B. 218, holds that the exchange of Mexican 50-peso bullion-type gold coins for Austrian 100-corona bullion-type gold coins qualifies for nonrecognition of gain under the provisions of section 1031(a) of the Code. The gold coins described in Rev. Rul. 76-214 were restrikes and were not circulating mediums of exchange in their respective countries and, therefore, were not currency, or money as that term is used in section 1031 of the Code.

In Rev. Rul. 76-249, 1976-2 C.B. 21, a taxpayer exchanged real property with a fair market value of $6,000 for United States silver coins with a face value of $2,000 and a fair market value of $6,000. The revenue ruling holds that silver coins received for the real property are to be treated as property and not as money. Therefore, the amount realized by the taxpayer from the exchange was the fair market value of the silver coins ($6,000) rather than the face amount of the coins ($2,000).

Rev. Rul. 79-143, 1979-1 C.B. 264, holds that the exchange of United States $20 gold coins (numismatic-type coins) for South African Krugerrand gold coins (bullion-type coins) does not qualify for nonrecognition of gain under section 1031(a) of the Code because the numismatic-type coins and the bullion-type coins are not property of like kind.

In the present case the taxpayer exchanged gold bullion for Canadian Maple Leaf gold coins, which are legal tender in Canada to the extent of their face value of $50 each. However, because the value of the gold content in each Canadian Maple Leaf gold coin greatly exceeds its face value, it is not a circulating medium of exchange. Therefore, the Canadian Maple Leaf gold coin is property rather than money for purposes of section 1031(a) of the Code. See Rev. Rul. 76-214 and compare Rev. Rul. 76-249.

Because the Canadian Maple Leaf gold coins are bought and sold for their gold content, they are bullion-type coins. Therefore, the nature and character of the gold bullion and the Canadian Maple Leaf gold coins are the same, and they qualify as 'like kind' property as that term is used in section 1.1031(a)-1(b) of the regulations.

HOLDING

The taxpayer's exchange of gold bullion for Canadian Maple Leaf gold coins qualifies for nonrecognition of gain or loss under section 1031(a) of the Code.

REVENUE RULING 79-143

Internal Revenue Service (I.R.S.)
Revenue Ruling (Rev. Rul.)
Published: 1979

SALE OR EXCHANGE; LIKE KIND; GOLD COINS

Section 1031 — Exchange of Property Held for Productive Use or Investment, 26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment.

Sale or exchange; like kind; gold coins. The exchange of U.S. $20 gold coins (numismatic-type coins) for South African Krugerrand gold coins (bullion-type coins) does not qualify for nonrecognition of gain as a like kind exchange under section 1031 of the Code; Rev. Rul. 76-214 distinguished.

ISSUE

Does an exchange of numismatic-type coins held for investment for bullion-type coins held for investment qualify for nonrecognition of gain under section 1031 of the Internal Revenue Code of 1954?

FACTS

An individual taxpayer who is not a dealer in foreign or domestic coins purchased United States $20 gold coins as an investment. After the coins had appreciated in value, the taxpayer exchanged them for South African Krugerrand gold coins of equal total fair market value. A gain was realized by the taxpayer as a result of the exchange. The taxpayer will hold the South African Krugerrand gold coins as an investment.

The United States $20 gold coins exchanged by the taxpayer are numismatic-type coins. The value of numismatic-type coins is determined by their age, number minted, history, art and aesthetics, condition, and metal content. The South African Krugerrand gold coins received by the taxpayer are bullion-type coins. The value of bullion-type coins is determined solely on the basis of their metal content.

LAW AND ANALYSIS

Section 1031(a) of the Code provides that no gain or loss is recognized upon an exchange of property (not including evidences of indebtedness) held for productive use in trade or business or for investment for property of a like kind to be held either for productive use in trade or business or for investment.

Section 1.1031(a)-1(b) of the Income Tax Regulations provides that as used in section 1031(a) of the Code, the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class.

Section 1031(e) of the Code provides that the exchange of livestock of one sex for livestock of the other sex is not an exchange of property of like kind for purposes of the nonrecognition provision of section 1031(a), because, as the committee report cited below points out, the different sexes of livestock represent investments of different types, in one case an investment for breeding purposes, in the other an investment in livestock raised for slaughter. Section 1031(e) was enacted to clarify what was considered to be the correct interpretation of section 1031(a). See S. Rep. No. 91-552, 91st Cong., 1st Sess. 102 (1969), 1969-3 C.B. 423, 488-489.

Similarly, in this case, although the coins appear to be similar because they both contain gold, they actually represent totally different types of underlying investment, and therefore are not of the same nature or character. The bullion-type coins, unlike the numismatic-type coins, represent an investment in gold on world markets rather than in the coins themselves. Therefore, the bullion-type coins and the numismatic-type coins are not property of like kind.

HOLDING

The exchange of United States $20 gold coins for South African Krugerrand gold coins does not qualify for nonrecognition of gain under section 1031(a) of the Code.

Rev. Rul. 76-214, 1976-1 C.B. 218, which holds that the exchange of Mexican 50-peso gold coins for Austrian 100-corona gold coins, both of which are official government restrikes, qualifies for nonrecognition of gain under section 1031(a) of the Code, is distinguishable because that Revenue Ruling involves only the exchange of bullion-type coins for bullion-type coins.

REVENUE RULING 57-365

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: 1957

Section 1.1031 — Property Held for Productive Use In Trade or Business or for Investment

26 CFR 1.1031(a)-1

Where the parent corporation of a telephone system causes one of its operating subsidiary companies to exchange all of its assets, including both real estate and personal property (but not including items of inventory and securities), for all of the similar assets of another operating telephone company and cash to equalize the value of the assets exchanged, an exchange of the assets of one such business for identical assets of another such business will be considered an exchange of 'property of like kind' within the meaning of section 1031 of the Code, on which, pursuant to the provisions of section 1031(b), gain, if any, will be recognized only to the extent of the cash received. Cf. Aaron F. Williams v. McGowan, 152 Fed.(2d) 570; also Rev. Rul. 55-79, C.B. 1955-1, 370.

REVENUE PROCEDURE 2003-39

Internal Revenue Service (IRS)
Revenue Procedure (Rev. Proc.)
Released: May 7, 2003
Published: June 2, 2003

LIKE-KIND EXCHANGES; LKE PROGRAMS

26 CFR 1.1031(a)-1: Property held for productive use in trade or business or for investment; 1.1031(k)-1: Treatment of deferred exchanges.

Like-kind exchanges; LKE programs. Safe harbor rules are provided under section 1031 of the Code, which allows for deferral of gain realized on a like-kind exchange of property, with respect to programs involving ongoing exchanges of tangible personal property using a single intermediary ("LKE Programs").

SECTION 1. PURPOSE

This revenue procedure provides safe harbors with respect to programs involving ongoing exchanges of tangible personal property using a single intermediary, as described in section 3.02 of this revenue procedure (an "LKE Program").

SECTION 2. BACKGROUND

.01 Section 1031(a)(1) 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 ("relinquished property") if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment ("replacement property").

.02 Section 1031(a)(3) provides that replacement property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property (the "45-day identification period"); or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extensions) for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Section 1.1031(k)-1(a) defines a deferred exchange as an exchange in which, pursuant to an agreement, the taxpayer transfers relinquished property and subsequently receives replacement property. In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money).

.04 Section 1.1031(k)-1(c)(1) provides that any replacement property that is received by the taxpayer before the end of the 45-day identification period will be treated in all events as identified before the end of the 45-day identification period.

.05 Section 1.1031(k)-1(f)(1) provides that if a taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives the replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive replacement property.

.06 Section 1.1031(k)-1(g) sets forth safe harbors involving a qualified escrow account, a qualified trust, or a qualified intermediary, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of Â§ 1031 and the regulations.

.07 Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer.

.08 Section 1.1031(k)-1(g)(4)(iv) provides that the intermediary will be treated as acquiring or transferring property, as the case may be, if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement for the acquisition or transfer of property and, pursuant to that agreement, the property is transferred.

.09 Section 1.1031(k)-1(g)(4)(v) provides that an intermediary will be treated as entering into an agreement for the acquisition or transfer of property if the taxpayer's rights in the agreement are assigned to the intermediary, and the other parties to the acquisition or transfer agreement are notified in writing of the assignment on or before the date of the relevant transfer of property (the "Assignment Safe Harbor"). Under the Assignment Safe Harbor, there is no requirement that the taxpayer also assign or delegate its obligations arising under the agreement.

.10 Section 1.1031(k)-1(g)(6) provides that an agreement with an escrow holder, trustee or qualified intermediary must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held in the qualified escrow or trust or by the qualified intermediary.

.11 Sections 1.1031(k)-1(g)(3) and (4) provide that the application of the safe harbor requires that in the case of a qualified escrow account, a qualified trust, or a qualified intermediary, the escrow holder, trustee, or intermediary must not be a "disqualified person."

.12 Section 1.1031(k)-1(k)(2) provides that a person that is the agent of the taxpayer at the time of the transaction is a disqualified person. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of Section 1.1031-1(k)(2), performance of the following services will not be taken into account: (a) services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Â§ 1031; and (b) routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

.13 The Service and Treasury Department have determined that it is in the best interest of sound tax administration to provide taxpayers with guidance regarding the qualification of LKE Programs under Section 1031. Accordingly, this revenue procedure provides safe harbors that clarify the application of Section 1031 and the regulations thereunder to LKE Programs.

SECTION 3. SCOPE AND DEFINITIONS

.01 Exclusivity. This revenue procedure provides safe harbors for certain aspects of the qualification under Section 1031 of certain exchanges of property pursuant to LKE Programs. The principles set forth in sections 4 through 6 of this revenue procedure have no application to any federal income tax determinations other than determinations that involve LKE Programs qualifying for one or more of the safe harbors. For a transaction to qualify under Section 1031, it must also satisfy the requirements of Section 1031 for which safe harbors are not provided in this revenue procedure (e.g., whether property involved in an exchange is considered like-kind property within the meaning of Section 1031).

.02 LKE Program. For purposes of this revenue procedure, an "LKE Program" is an ongoing program involving multiple exchanges of 100 or more properties. Although LKE Programs may differ in various ways, an LKE Program must have all of the following characteristics:

(1) The taxpayer regularly and routinely enters into agreements to sell tangible personal property as well as agreements to buy tangible personal property;

(2) The taxpayer uses a single, unrelated intermediary to accomplish the exchanges in the LKE Program;

(3) The taxpayer and the intermediary enter into a written agreement ("master exchange agreement");

(4) The master exchange agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the intermediary as provided in Section 1.1031(k)-1(g)(6);

(5) In the master exchange agreement, the taxpayer assigns to the intermediary the taxpayer's rights (but not necessarily its obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property;

(6) The taxpayer provides written notice of the assignment to the other party to each existing and future agreement to sell relinquished property and/or to purchase replacement property;

(7) The taxpayer

(a) implements a process that identifies potential replacement property or properties before the end of the identification period for the relinquished property or group of relinquished properties of which it is disposing in each exchange,

(b) complies with the identification requirement by receiving replacement property or properties before the end of the 45-day identification period,

or

(c) satisfies the identification requirements by a combination of the approaches in (a) and (b);

(8) The taxpayer implements a process for collecting, holding, and disbursing funds (which may include the use of joint taxpayer and intermediary bank accounts, or accounts in the name of a third party for the benefit of both the taxpayer and the intermediary) that ensures that the intermediary controls the receipt, holding, and disbursement of all funds to which the intermediary is entitled (i.e., proceeds from the sale of relinquished properties);

(9) Relinquished property or properties that are transferred are matched with replacement property or properties that are received in order to determine the gain, if any, recognized on the disposition of the relinquished property and to determine the basis of the replacement property; and

(10) The taxpayer recognizes gain or loss on the disposition of relinquished properties that are not matched with replacement properties, and the taxpayer takes a cost basis in replacement properties that are received but not matched with relinquished properties.

A taxpayer may conduct more than one LKE Program simultaneously. In such a case, each LKE Program is evaluated separately for purposes of determining whether that LKE Program qualifies for the safe harbors of this revenue procedure.

.03 No Inference. The Service recognizes that exchanges of property pursuant to LKE Programs may qualify for nonrecognition treatment under Section 1031 although they fall outside the safe harbors provided in this revenue procedure. No inference is intended with respect to the federal income tax treatment of transfers of relinquished property and acquisitions of replacement property that do not satisfy the terms of the safe harbors provided in this revenue procedure.

.04 Scope of Safe Harbors. Each of the paragraphs under sections 4, 5, and 6 of this revenue procedure is considered a separate and distinct safe harbor. Therefore, a taxpayer who fails to qualify for the benefits of one safe harbor may nevertheless qualify for the benefits of another safe harbor.

SECTION 4. EXCHANGES OF RELINQUISHED PROPERTY AND REPLACEMENT PROPERTY

.01 Separate and Distinct Exchanges. In the case of an LKE Program, the taxpayer's transfer of each relinquished property or group of relinquished properties and the taxpayer's corresponding receipt of each replacement property or group of replacement properties with which the relinquished property or group of relinquished properties has been matched by the taxpayer is treated as a separate and distinct exchange for purposes of Â §1031. The determination of whether a particular exchange qualifies under Section 1031 is made without regard to any other exchange. Thus, if a particular exchange of a relinquished property or group of relinquished properties for a replacement property or group of replacement properties pursuant to an LKE Program fails to qualify under Section 1031, such failure will not affect the application of Section 1031 to any other exchange pursuant to the LKE Program.

.02 45-day Identification Period. Replacement property that is received within the 45-day identification period or that is otherwise properly identified as provided in Section 1.1031(k)-1(c) is treated as satisfying the requirement of Â§ 1031(a)(3) that replacement property be identified, notwithstanding that it may not be matched with relinquished property until after the end of the 45-day identification period. The replacement property must, however, be matched no later than the due date (determined with regard to extensions) of the taxpayer's return.

SECTION 5. ACTUAL OR CONSTRUCTIVE RECEIPT OF MONEY OR OTHER PROPERTY

For purposes of this section, any requirement that the taxpayer transfer money or other property to the qualified intermediary will be deemed to be satisfied if the amount of money held by the qualified intermediary and the amount of money in any joint account (as described in Â§ 5.02 of this revenue procedure) equals or exceeds the amount of proceeds from the sale of relinquished property (including the amount that is required to be transferred by the taxpayer) that has not yet been used to acquire replacement property.

.01 Receipt of Checks and Other Negotiable Instruments. A taxpayer engaged in an LKE Program will not be considered to be in actual or constructive receipt of money or other property as a result of processing a check or other negotiable instrument made payable to a person other than the taxpayer if:

(1) The check or other negotiable instrument has not been endorsed by the person to whom the check or other negotiable instrument is made payable;

(2) The person to whom the check or other negotiable instrument is made payable is not a disqualified person as defined in Section 1.1031(k)-1(k);

and

(3) The check or other negotiable instrument is forwarded to or for the benefit of a qualified intermediary or deposited into an account in the name of the qualified intermediary, a joint account, or an account in the name of a third party (other than a disqualified person as defined in Section 1.1031(k)-1(k)) for the benefit of both the taxpayer and the qualified intermediary.

.02 Joint Accounts. A taxpayer engaged in an LKE Program will not be considered to be in actual or constructive receipt of proceeds from the sale of relinquished property deposited into or held in a joint bank, trust, escrow, or similar account in the name of the taxpayer and the qualified intermediary, or in an account in the name of a third party (other than a disqualified person as defined in Section 1.1031(k)-1(k)) for the benefit of both the taxpayer and the qualified intermediary, if:

(1) The account is used to collect, hold, and/or disburse proceeds arising from the sale of relinquished property for the benefit of the qualified intermediary;

(2) The agreement setting forth the terms and conditions with respect to the account requires authorization from the qualified intermediary to transfer proceeds from the sale of relinquished properties out of the account; and

(3) The agreement setting forth the terms of the taxpayer's and qualified intermediary's rights with respect to, or beneficial interest in, the account expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of proceeds from the sale of relinquished property held in the joint account as provided in Section 1.1031(k)-1(g)(6).

The account may also be used by the parties for other purposes provided that such use does not undermine the qualified intermediary's right to control the proceeds from the sale of relinquished property.

.03 Funds Netting. A taxpayer engaged in an LKE Program will not be considered to be in actual or constructive receipt of money or other property as a result of transferring relinquished property solely because an amount owed by the taxpayer to the buyer (other than a lease security deposit) is netted against the sales price of the relinquished property, provided that, as required by the master exchange agreement, funds equal to the full amount of sales proceeds from the relinquished property are transferred to or for the benefit of the qualified intermediary by the opening of the next day's business. Likewise, a taxpayer acquiring replacement property in a like-kind exchange will not be considered to be in actual or constructive receipt of money or other property solely because an amount owed by the seller to the taxpayer is netted against the purchase price of the property and the qualified intermediary transfers to the taxpayer funds in an amount equal to the amount owed by the seller to the taxpayer so that the qualified intermediary expends the full amount of the purchase price obligation for the replacement property.

.04 Taxpayer As Lender to Purchaser. If a taxpayer that is engaged in an LKE Program lends money to the buyer for the purchase of the taxpayer's relinquished property, the taxpayer's receipt of the buyer's promissory note or other evidence of indebtedness will not be considered actual or constructive receipt of money or other property if:

(1) The taxpayer makes similar loans in the ordinary course of its business operations;

(2) The buyer is not obligated to obtain financing from the taxpayer for the purchase of the relinquished property, but rather is free to borrow the funds from another lender;

(3) The taxpayer's loan to the buyer is an arm's-length transaction at the prevailing market terms; and

(4) As required by the master exchange agreement, the taxpayer promptly transfers funds equal to the loan proceeds (plus a market rate of interest on such amount for the period between the date of the sale of the relinquished property and the date of the transfer of the loan proceeds to the qualified intermediary) to or for the benefit of the qualified intermediary.

05. Application of Lease Security Deposit To Purchase Price. In the case of a taxpayer that engages in an LKE Program and is the lessor of the property being purchased by the buyer-lessee, the buyer-lessee's application of its lease security deposit to the purchase price of the relinquished property will not be considered actual or constructive receipt of money or other property provided that, as required by the master exchange agreement, the taxpayer promptly transfers funds equal to the lease security deposit (plus a market rate of interest on such amount for the period between the date of the sale of the relinquished property and the date of the transfer of the security deposit to the qualified intermediary) to or for the benefit of the qualified intermediary.

SECTION 6. DEFINITION OF QUALIFIED INTERMEDIARY

.01 In General. For purposes of determining whether an intermediary is a disqualified person in the context of an LKE Program, the intermediary will not fail to be a qualified intermediary merely because the intermediary:

(1) is assigned the taxpayer's rights in its agreements to sell relinquished properties that ultimately are not matched with replacement properties under the taxpayer's LKE Program;

(2) is assigned the taxpayer's rights in its agreements to buy replacement properties that ultimately are not matched with relinquished properties under the taxpayer's LKE Program;

(3) receives funds with respect to the transfer of relinquished property that ultimately is not matched with replacement property under the taxpayer's LKE Program; or

(4) pays funds with respect to the acquisition of replacement property that ultimately is not matched with relinquished property under the taxpayer's LKE Program.

.02 Assignment Safe Harbor. The taxpayer's assignment in the master exchange agreement to the intermediary of the taxpayer's rights (but not necessarily its obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property, and the taxpayer's written notice of the assignment to the other party to each agreement to sell relinquished property and/or to purchase replacement property on or before the date of the relevant transfer of property, will be effective to satisfy the Assignment Safe Harbor and notice requirement under Section 1.1031(k)- 1(g)(4)(v).

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1834.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.
The collections of information in this revenue procedure are in sections 5 and 6. This information is required by the Service to provide safe harbors under Section 1031 to taxpayers participating in LKE Programs for federal income tax purposes. The likely respondents are finance companies; subsidiaries of manufacturers; or banks that purchases retail leases and retail installment sale contracts from dealers of automobiles or other types of equipment.

The estimated total annual reporting and recordkeeping burden is 8,600 hours.

The estimated annual burden per respondent/recordkeeper varies from 45 minutes to 75 minutes, depending on individual circumstances, with an estimated average of 60 minutes. The estimated number of respondents and recordkeepers is 8,600.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Elizabeth Kaye of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Kaye at (202) 622- 4920 (not a toll-free call).

PRIVATE LETTER RULING 200550005

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: December 10, 2004
August 30, 2004

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

CC:ITA:B05
PLR-111387-04
DO:

Dear ***:

This letter responds to your request for two rulings. First, you have requested a ruling that sport utility vehicles ("SUVs") will be treated as like kind to passenger automobiles for purposes of section 1031 of the Internal Revenue Code ("Code") and the regulations thereunder. Second, you have requested a ruling that the deferred like-kind exchange program implemented by Subsidiary meets the assignment safe harbor and notice requirements in section 6.02 of Rev. Proc. 2003-39, 2003-22 IRB 971.

FACTS

Subsidiary is wholly owned by Taxpayer. Taxpayer and Subsidiary file a consolidated return. Subsidiary is primarily engaged in the business of leasing vehicles to consumers and issuing loans to consumers for the purchase of vehicles. Leases are originated through a national network of independent dealers of Taxpayer's vehicles. Following the standard industry practice, customers are commonly given the option of either leasing or purchasing a new vehicle from the dealer. When a customer desires to lease a new vehicle, the dealer offers to initiate a lease on behalf of Subsidiary. Subsidiary regularly disposes of leased vehicles and replaces them with new vehicles as lease term expiration and customer demand require. Subsidiary currently maintains a portfolio of vehicles leased to customers. These vehicles include automobiles and sport utility vehicles ("SUVs").

Subsidiary has implemented a deferred like-kind exchange program ("LKE Program") for these vehicles. Consequently, Subsidiary has structured its vehicle leasing operations with the intention that the disposition of a vehicle coming off lease (a relinquished vehicle) by Subsidiary to an unrelated party and the acquisition by Subsidiary of a vehicle recently leased from a dealer (a replacement vehicle) will qualify as a like-kind exchange under section 1031. Relinquished vehicles are typically sold to the dealer, the lessee, or at auction to a third party. Replacement vehicles are usually purchased from a member of the dealer network.

The LKE Program is an ongoing program involving multiple exchanges of 100 or more vehicles. To meet the requirements of section 1031, Subsidiary entered into an Exchange Agreement with QI, under which QI is to act as a qualified intermediary under section 1.1031(k)-1(g)(4) of the Income Tax Regulations.

QI maintains different types of accounts for Subsidiary: Collection Accounts; Concentration Accounts; Disbursement Accounts and Investment Accounts. The Collection Accounts hold amounts received by QI from the sale of relinquished vehicles as well as other receipts. Those amounts related to the LKE Program are transferred to the Concentration Accounts by the QI. Each day, funds from the sale of relinquished vehicles are transferred by the QI from the Concentration Accounts to the Disbursement Accounts in order to fund the acquisition of replacement vehicles from dealers. All amounts expended by QI in the acquisition of vehicles are funded by disbursements directly from the Disbursement Accounts by check or electronic funds transfer.

Under the Exchange Agreement, Subsidiary makes a master assignment to QI of its rights (but not its obligations) in its existing and future agreements to purchase replacement property and to sell relinquished property. In all instances, the seller of replacement property receives written notice prior to the time that the replacement property is transferred to Subsidiary. Notice is provided to dealers in lease agreements, credit approval faxes, and funding approval faxes. The purchasers of relinquished property also receive written notice prior to transfer. Notice is provided to lessees, dealers and third parties in written payoff quotes and, in the case of auction sales, electronic files submitted to the auction house and bills of sale.

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that in general, 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 1.1031(k)-1(a) of the regulations provides that a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In order to constitute a deferred exchange, the transaction must be an exchange (i.e. a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of section 1.1031(k)-1 are satisfied.

Your first ruling request is that SUVs will be treated as like kind to passenger automobiles for purposes of section 1031 of the Code and the regulations thereunder.

Section 1.1031(a)-1(b) provides that as used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that Code section, be exchanged for property of a different kind or class. As an example, section 1.1031(a)-1(c) provides that "a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose" are like kind.

Section 1.1031(a)-2(b) further provides as a safe harbor that depreciable tangible properties are of like class if they are either within the same General Asset Class, as defined in section 1.1031(a)-2(b)(2), or within the same Product Class, as defined in section 1.1031(a)-2(b)(3).

The General Asset Class and Product Class safe harbors in the regulations simplify the determination of whether depreciable tangible personal property is of a like kind, but they are not the exclusive method for making this determination. For depreciable tangible personal property to be considered of like kind, the property can be either like kind or like class. Section 1.1031(a)- 2(a) of the regulations provides that "an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class." Thus, two properties can be in different General Asset Classes (and thus not be of a like class) and yet be of like kind.

The like-kind property standard has been interpreted more narrowly in the case of exchanges of personal property as compared to exchanges of real property. See California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982). Even within the more restrictive parameters of the like-kind standard as applied to personal property, the differences between an automobile and an SUV do not rise to the level of a difference in nature or character but are merely a difference in grade or quality. Thus, we conclude that the two are like kind property.

The second ruling you have requested is that the deferred like-kind exchange program implemented by Subsidiary meets the assignment safe harbor and notice requirements in section 6.02 of Rev. Proc. 2003-39, 2003-22 IRB 971.

Section 1.1031(k)-1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(4)(v) provides that an intermediary will be treated as entering into an agreement for the acquisition or transfer of property if the taxpayer's rights in the agreement are assigned to the intermediary, and the other parties to the acquisition or transfer agreement are notified in writing of the assignment on or before the date of the relevant transfer of property ("Assignment Safe Harbor"). Under the Assignment Safe Harbor, there is no requirement that the taxpayer also assign or delegate its obligations under the agreement.

Rev. Proc. 2003-39 provides certain safe harbors with respect to LKE programs involving ongoing exchanges of tangible personal property using a single intermediary. Section 6.02 of that revenue procedure provides that the taxpayer's assignment in the master exchange agreement to the intermediary of the taxpayer's rights (but not necessarily it obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property, and the taxpayer's written notice of the assignment to the other party to each agreement to sell relinquished property and/or to purchase replacement property on or before the date of the relevant transfer of property, will be effective to satisfy the Assignment Safe Harbor under section 1.1031(k)-1(g)(4)(v).

In the instant case, Subsidiary has assigned to QI its rights to sell the relinquished property. In all instances, the purchaser receives written notice of the assignment prior to the time that the relinquished property is transferred to the purchaser. Notice is provided in written payoff quotes and, in the case of auction sales, electronic files submitted to the auction house and the bills of sale.

In addition, Subsidiary assigned its right to purchase replacement property to QI. In all instances, the seller receives written notice prior to the time that the replacement property is transferred to Subsidiary. Notice is provided to dealers in lease agreements, credit approval faxes, and funding approval faxes.

CONCLUSIONS

Accordingly, based on your representations and the above analysis, we conclude that SUVs and passenger automobiles are like kind property for purposes of section 1031 of the Code and the regulations thereunder. We further conclude that the deferred like-kind exchange program implemented by Subsidiary meets the Assignment Safe Harbor in section 6.02 of Rev. Proc. 2003-39, 2003-22 IRB 971.

Sincerely,

John M. Aramburu
Senior Counsel, Branch 5
Office of Associate Chief Counsel (Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200532008

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: August 12, 2005
May 9, 2005

Section 1031 -- Exchange of Property Held for Productive Use or Investment

LEGEND

Parent =
Taxpayer =
State A =
Services =
Xx =
Yy =
Ww =
Zz =
CCC =
AA =
Exchange Affiliates =
Other Affiliates =
EE =
FF =
BB =
Entity =
DATE ONE =
DATE TWO =
$x =
$y =

Dear ***:

This is in response to your request for a private letter ruling dated January 26, 2005, submitted by your authorized representatives as to the application of Section 1031 of the Internal Revenue Code to the below transaction. Specifically, you have requested a ruling that the transfer to AA of certain radio frequency spectrum ("spectrum") rights pursuant to the CCC and the receipt back of certain other spectrum rights from AA qualify as a like-kind exchange under Section 1031 such that Taxpayer will recognize no gain or loss pursuant to the transaction.

FACTS

The following facts are pertinent to your ruling request. Taxpayer is a State A corporation. Taxpayer is engaged in the business of providing Services. Taxpayer operates its business through an affiliated group of corporations, which files a consolidated federal income tax return. Taxpayer has certain operating companies, which are divided geographically. For financial and tax reporting purposes, Taxpayer and its affiliates use the accrual method of accounting and an accounting period based on the calendar year which ends on December 31.

Taxpayer's business makes use of portions of the spectrum pursuant to licenses granted by the Federal Communications Commission ("FCC"). FCC licenses, including Taxpayer's licenses, are granted on a geographic basis, reflecting different economic markets. Pursuant to its FCC licenses and prior to the issuance of the CCC, Taxpayer held rights to certain megahertz of spectrum in the Ww band in numerous markets. Taxpayer also held rights to additional megahertz of spectrum in the Xx band and certain other megahertz of spectrum in the Zz band. Taxpayer used its spectrum rights in the Xx and Zz bands in its business to provide Services to its customers. Taxpayer did not use its spectrum rights in the Ww band in its business, but instead held those spectrum rights for investment.

Pursuant to CCC, certain of Taxpayer transferred to AA rights to certain spectrum and received back from AA rights to certain other spectrum. Specifically,(i) Taxpayer transferred spectrum rights in the Ww and Xx bands (and incurred certain obligations to expend cash in connection with the transaction); and, in exchange, (ii) Taxpayer received spectrum rights in the *** Xx band and spectrum rights in the Yy band. Those Taxpayer affiliates that will be transferring spectrum rights and receiving back spectrum rights in the exchange are the Exchange Affiliates listed in Exhibit A.
EE, certain of Taxpayer's operating companies, hold FCC licenses directly. FF, certain of Taxpayer's other operating companies, do not hold FCC licenses directly, but instead, their FCC licenses are held by affiliates and leased to FF. Taxpayer's Ww band spectrum licenses are held by a separate company. Certain Xx spectrum licenses are held for investment by BB.

The FCC was established by the Communications Act of 1934 (the "Communications Act"), 47 U.S.C. Section 151 et seq., as amended, as an independent United States government agency to regulate television, radio, wire, satellite, telephony and cable services in the United States and all United States territories. The FCC has exclusive authority regarding the non-governmental use of spectrum, including authority to allocate spectrum, assign frequencies and grant licenses to operate on spectrum.

Pursuant to Section 301 of the Communications Act, the FCC licenses at issue grant to the licensee the right to use and transmit radio frequency signals subject to specified rules and regulations applicable to the defined service category and other general terms and conditions imposed on the licensee by the FCC. Traditionally, the FCC licenses spectrum on an exclusive basis, giving licensees a right to operate on a given set of frequencies. FCC licensees are required to pay annual regulatory fees associated with their licenses and the use of designated frequencies. Spectrum rights can be obtained at auction or by assignment from another licensee. Any licensee seeking to transfer its license must apply to the FCC for prior written approval. The FCC also permits a licensee to lease certain spectrum rights to a third party. As long as a licensee adheres to the rules and regulations promulgated by the FCC and to the terms and conditions of its license, the licensee may assume that its license will be renewed by the FCC.

Previously, licensees in the Xx band were ***: licensees that ***. Licensees that use ***.

Pursuant to *** the CCC, the ***. The CCC *** The CCC also *** Pursuant to the CCC, all *** as of the CCC's DATE ONE. The CCC requires the *** in the Xx band consistent with the The CCC required Taxpayer to transfer its spectrum rights in the *** band. In return, Taxpayer was *** spectrum rights in the *** band. Taxpayer represented that all of the spectrum rights received pursuant to the CCC are held for use in Taxpayer's Services business or for investment.

Pursuant to the CCC, Taxpayer's transfer of spectrum rights in the *** band and the *** Taxpayer of spectrum rights in the *** band *** FCC *** licenses. The CCC specified that all Xx licenses affected by the CCC, *** DATE ONE. However, the CCC conditioned the *** Taxpayer's licenses on Taxpayer's acceptance of certain conditions and obligations in the CCC. Due to certain permissible delays, Taxpayer was not required to accept these conditions and obligations by DATE ONE, and instead, Taxpayer's acceptance occurred after, rather than before, the DATE ONE. Therefore, the *** of Taxpayer's Xx licenses and its receipt of spectrum rights in the Yy band occurred on the date Taxpayer did accept the conditions and obligations of the CCC, which is DATE TWO.

Pursuant to the CCC, Taxpayer transferred to AA its spectrum rights in the Ww band. Taxpayer's Ww band licenses were *** spectrum rights in the *** Xx and Yy bands.

The CCC also requires Taxpayer to pay certain costs ***.

To ensure that there are sufficient funds to pay such costs, the CCC required Taxpayer to obtain a $x letter of credit. If these costs exceed $x, however, Taxpayer will be required to pay the additional costs. The Taxpayer represents that the aggregate value of the spectrum rights spectrum rights being received ("Replacement Property") in the exchange exceeds the aggregate value of the spectrum rights being transferred ("Relinquished Property") by $y. Moreover, each Exchange Affiliate transferring spectrum rights pursuant to the CCC *** Pursuant to the CCC, Taxpayer is given credit for any amounts to be expended in paying the above costs. Upon completion of the transaction, Taxpayer is required to pay Entity the amount by which the value of spectrum rights received exceeds the value of spectrum rights transferred plus the amounts ultimately paid by Taxpayer in paying these costs. Notwithstanding that Taxpayer received spectrum rights in the Yy band on the DATE TWO and that Taxpayer's Yy band licenses take effect on that date, Taxpayer's *** is conditioned on the following actions taken by Taxpayer: (1) obtaining a letter of credit that provides assurance that $x will be available for paying certain costs, notwithstanding the financial condition of Taxpayer; (2) identifying a ***; (3) providing an opinion from *** containing a detailed legal analysis indicating that the *** will not treat the letter of credit or proceeds thereof as property of Taxpayer ***; (4) providing a letter binding all of the Taxpayer affiliates to perform the obligations imposed on Taxpayer in the CCC; (5) obtaining AA approval of all documents submitted above; and (5) providing a letter acknowledging that Taxpayer is aware of the risks and possible delays related to the CCC and will not sue AA. In addition, Taxpayer's rights in the Yy band is further conditioned upon the *** licensees in the Yy band in ***.

Moreover, notwithstanding that Taxpayer received its spectrum rights in the Yy band on the DATE TWO, Taxpayer may be required *** in the manner set forth in the CCC. Specifically, Taxpayer may be required *** its spectrum rights if it does not complete the following: (i) the *** and (ii) the ***. In addition, failure to *** and/or to meet any financial obligations set forth in the CCC can result in ***. As a general matter, Taxpayer's failure to comply with any of the other conditions specified in the CCC may also lead to ***.

It is also noted that the Other Affiliates, which are listed in Exhibit B attached, are not part of this private letter ruling request even though the Other Affiliates also transferred licenses for certain spectrum rights to AA. The Other Affiliates, however, did not receive licenses for spectrum rights (i.e., Replacement Property) from AA in the exchange. Instead, each of the Other Affiliates received intercompany receivables of the Taxpayer in the value of the spectrum rights transferred by that affiliate. The obligors of these intercompany receivables are other affiliates of the Taxpayer. Consequently, no determination or ruling is being made concerning the federal income tax consequences of this exchange with respect to the Other Affiliates.

LAW AND ANALYSIS

As stated above, you have requested a ruling, on behalf of the Exchange Affiliates, that the transfer and receipt of spectrum rights pursuant to CCC qualify as a like-kind exchange under Section 1031 such that no gain or loss is recognized pursuant to the transaction.

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. Under Section 1031(a)(3), any property received by the taxpayer shall be treated as property which is not like-kind property if such 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 such property is received after the earlier of the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or 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. See generally section 1.1031(a)-1 of the Income Tax Regulations.

Section 1.1031(a)-1(b) provides that "like kind" refers to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under Section 1031, be exchanged for property of a different kind or class. See also section 1.1031(a)-2(a).

Section 1.1031(a)-2(c)(1) provides generally that an exchange of intangible personal property or non-depreciable personal property qualifies for nonrecognition of gain or loss under Section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates. For example, an exchange of a copyright on a novel for a copyright on a different novel is a like kind exchange, but an exchange of a copyright on a novel for a copyright on a song is not a like kind exchange. See section 1.1031(a)- 2(c)(3).

We note that Section 1031(a)(1) requires that both the property being exchanged and the property being received in the exchange must be held for productive use in a trade or business or for investment. The Taxpayer represents that the licenses for the spectrum rights being transferred (Relinquished Property) and the licenses for the spectrum rights being received (Replacement Property) have been, or will be, held for productive use in its trade or business of providing Services or held for investment. Accordingly, this statutory requirement is not in issue. Also, the reciprocal transfer of spectrum rights between Taxpayer and AA constitutes an "exchange," which occurred on DATE TWO. We further note that, for purposes of satisfying the 45-day statutory period for the identification of replacement property and the 180-day statutory period for the receipt of the replacement property in Section 1031(a)(3), the transfer and receipt of the spectrum rights in issue occurred essentially on the same date. Consequently, the statutory identification and replacement requirements are not in issue either. The main issue for determination in this ruling request is whether, with respect to the exchange in this case, the spectrum rights being transferred and the spectrum rights being received are like-kind property for purposes of Section 1031.

For purposes of the above regulations, the FCC licenses for the spectrum rights being exchanged in this case are intangible personal property. The determination of whether they are like kind will depend on (1) the nature or character of the rights involved; and (2) the nature or character of the underlying property to which the intangible personal property relates.

In determining whether the first prong in the above test is met, one example in the regulations addresses whether a copyright on a novel is like kind to a copyright on a different novel. See example (1) in section 1.1031(a)- 2(c)(3). This example's conclusion that the copyrights are like kind is based, in part, on a comparison of the nature and character of the rights involved with the copyrights. In the case of a copyright, federal law gives the holder of the copyright certain rights regarding the copyrighted material. Thus, as to the first inquiry, the nature or character of the rights involved, one copyright generally will be like kind to another.

In the instant case, the determination of whether the FCC licenses for spectrum rights being transferred to AA in this exchange are like kind to the FCC licenses for spectrum rights being received by the Taxpayer in this exchange depends, in part, on the nature or character of the rights involved with the licenses.

The nature or character of the rights involved here are determined by examining the substance of the specific rights granted in the FCC licenses. These rights are granted by the federal government, which, on behalf of the public, manages and controls the use of the electromagnetic spectrum. The government delegates authority to the FCC to issue licenses to users of the electromagnetic spectrum for certain broadcasting purposes. An FCC license enables the licensee to broadcast to the public over the electromagnetic spectrum for the duration of the license. One FCC license will differ from another regarding specific terms and conditions of operation. However, despite these differences, the nature or character of the rights conferred on each FCC licensee by the FCC license will basically be the same.

In a situation also addressing the exchange of FCC licenses, the Service in TAM 200035005 (May 11, 2000), concluded that the exchange of FCC radio licenses for an FCC television license qualified as a like kind exchange under Section 1031. Concerning the first prong of the above test (i.e., the nature or character of the rights involved with respect to the intangible personal properties being exchanged), an examination of the FCC licenses at issue in the TAM revealed that each of the FCC licenses conferred a right to use the referenced radio transmitting apparatus to broadcast on a designated channel and frequency range, at designated hours of operation, at designated geographic locations, at a maximum effective radiated power, and using antenna with certain antenna system specifications. This right was specifically enumerated in each FCC license, regardless of whether the license relates to a television station, an FM radio station, or an AM radio station. Other than the different labels, the only differences between the various FCC licenses were the specific operating parameters (such as frequency, operating hours, power, and antenna information) and geographic location. The TAM specifically found that these differences did not change the nature or character of the rights granted in the licenses, but were merely differences in grade or quality. Accordingly, the TAM concluded that differences in assigned frequencies were not differences in nature or character, but are merely differences in grade or quality.

Similarly, in this case, Taxpayer will transfer to AA spectrum rights in Ww and Xx bands and, in return, will receive back from AA spectrum rights in *** Xx and Yy bands. As in the case of TAM 20003005, the differences in spectrum rights in the different bands are the specific operating parameters (i.e., frequency, power and antenna specifications) and geographic location. The spectrum rights comprising the Relinquished Property transferred by the Taxpayer to AA and the spectrum rights comprising the Replacement Property received by the Taxpayer from AA are all suitable for use by Taxpayer in its business of providing Services. Because any such differences in spectrum rights involved in the exchange do not involve the nature or character of these spectrum rights, but are merely differences in grade or quality of such rights, we conclude that the spectrum rights being transferred and the spectrum rights being received are like kind.

In this case, the determination of whether the FCC licenses for spectrum rights being transferred to AA in this exchange are like kind to the FCC licenses for spectrum rights being received by the Taxpayer in this exchange will also depend on the nature or character of the underlying property to which the intangible personal property relates, which is the second prong of the above test in section 1.1031(a)-2(c)(1) the regulations.

For instance, example (3) in section 1.1031(a)-2(c)(3) of the regulations states that a copyright on a novel is not like kind to a copyright on a song. In that example, a copyright for a novel would expressly reference the underlying novel and a copyright for a song would expressly reference the underlying song since these are the properties protected by the copyrights. It is the fact that a novel and a song are not like kind that causes these two intangible properties to be not like kind. Accordingly, in numerous situations the Service has examined whether the nature or character of the underlying properties to which an exchange of intangibles relates are like kind in order to determine if the exchange of the intangibles is like kind.

The rights conferred upon holders of FCC licenses are described in the FCC licenses themselves. See Section 301 of the Communications Act. Thus, the appropriate manner of identifying the underlying property to which the FCC license relates is to look to the license itself, which principally relates to the use of the transmitting apparatus. Specifically, FCC licenses contain the rights to use transmitting apparatus to broadcast over a portion of the electromagnetic spectrum at a certain power in a designated geographic area. Although an FCC license clearly regulates the manner in which the licensee may use its transmitting equipment, for purposes of Section 1031, the assigned frequency of the electromagnetic spectrum referred to in each license is the underlying property to which the license relates.

Having identified the property underlying an FCC license as the assigned broadcast frequency of the electromagnetic spectrum, we must determine whether the differences between the assigned frequency of the electromagnetic spectrum transferred by the Taxpayer in the Ww and Xx bands and the assigned frequency of the electromagnetic spectrum received by the Taxpayer in the *** Xx band and spectrum rights in the Yy band are differences in nature or character or are merely differences in grade or quality.

We note that the bandwidth of a particular frequency dictates the amount of information that the frequency can carry. In comparing the nature or character of the assigned frequency of the electromagnetic spectrum referred to in each FCC license, it is clear that the spectrum rights transferred by the Taxpayer have different bandwiths from the spectrum rights received by the Taxpayer. However, even the narrowest interpretation of the like kind standard does not require that one property be identical to another or that they be completely interchangeable. As stated earlier, the spectrum rights being transferred by the Taxpayer to AA and the spectrum rights being received by the Taxpayer from AA are all suitable for use in the Taxpayer's business of providing Services. Thus, we find that the bandwith differences in the spectrum rights being transferred and being received in this exchange, which underlie these FCC licenses, are not differences in nature or character, but are merely differences in grade or quality, and thus constitute like-kind property.

CONCLUSION

Accordingly, we conclude that Taxpayer's exchange of FCC licenses for spectrum rights in the Ww and Xx bandwiths for FCC licenses for spectrum rights in the *** Xx bandwith and the Yy bandwith qualify as a like kind exchange under Section 1031.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of any other aspect of any transaction or item discussed or referenced in this letter. For instance, as noted above in the Facts, the Other Affiliates, which are listed in Exhibit B attached, are not part of this private letter ruling request even though the Other Affiliates also transferred licenses for certain spectrum rights to AA. The Other Affiliates, however, did not receive licenses for spectrum rights (i.e., Replacement Property) from AA in the exchange. Instead, each of the Other Affiliates received intercompany receivables of the Taxpayer in the value of the spectrum rights transferred by that affiliate. The obligors of these intercompany receivables are other affiliates of the Taxpayer. We make no determination or ruling concerning the federal income tax consequences of this exchange with respect to the Other Affiliates.

This ruling is directed only to the taxpayer requesting it.

Sincerely yours,

William A. Jackson
Branch Chief, Branch 5
Office of Associate Chief Counsel (Income Tax & Accounting)

PRIVATE LETTER RULING 200428020

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: July 9, 2004
March 31, 2004

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

CC:ITA:B04 - PLR-161761-03
Taxpayer =
QI =
QI Administrator =
Finance LP =
Trust =
Trustee =
mx =
dd =
Year 1 =
Year 2 =
Date 3 =
Date 4 =
Category A =
Category B =
Category C =
Category D =
rr =
ww =
wx =

Dear ***:

Taxpayer received a private letter ruling dated March 27, 2003 (the "original ruling"), addressing the federal income tax treatment under Section 1031 of the Internal Revenue Code and Income Tax Regulations thereunder of its program for exchanging mx (the "Like-Kind Exchange Program" or "LKE Program"). Taxpayer now seeks a supplemental ruling that certain modifications and additions to its LKE Program do not affect the previous rulings issued.

STATEMENT OF FACTS:

Unless otherwise indicated, the facts and legal analysis set forth in the original ruling are affirmed and incorporated by reference.

A. Description of Taxpayer's LKE Program.

As described in the original ruling, Taxpayer established the LKE Program under Section 1031 pursuant to the Master Exchange Agreement, dated ***, and as subsequently amended, among Taxpayer, individually and as Servicer, Finance LP, Trustee, QI and QI Administrator. Under the LKE Program, which is structured to meet the requirements of the "qualified intermediary" safe harbor under Section 1.1031(k)-1(g)(4), Taxpayer disposes of mx that meet the parameters established under the LKE Program for relinquished property ("RQ") and acquires mx that meet the LKE Program parameters for replacement property ("RP") through QI. In the Master Exchange Agreement, Taxpayer makes a blanket assignment to QI of its rights under sale contracts and purchase contracts. Taxpayer gives notice of these assignments to QI, to the purchasers of relinquished mx and to the sellers of replacement mx through a combination of blanket and transaction-specific notification methods. Currently, Taxpayer matches relinquished mx only with replacement mx acquired within 45 days of the date the relinquished mx were transferred. Taxpayer does not expressly or manually identify replacement mx, relying instead on the deemed identification provision of the second sentence of Section 1.1031(k)-1(c)(1), which provides that RP received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period. Thus, Taxpayer satisfies the statutory identification and receipt requirements under Section 1031(a)(3) by receiving RP before the end of the 45-day identification period.

Under substantiating facts presented, we issued the following rulings in a letter dated March 27, 2003:

1. Properties described as belonging to Categories A, B and C are of like-kind even if they do not belong to the same general asset class. Also, properties in Categories B, C and D are of like kind or like class because they are within the same Product Class.

2. Taxpayer's transfer of each RQ, or group of RQ, and the corresponding receipt of RP, or group of RP, in accordance with the Master Exchange Agreement will be treated as a separate and distinct exchange for purposes of Section 1031.

3. Each exchange in accordance with the Master Exchange Agreement of one or more RQ transferred for one or more RP will qualify for nonrecognition of gain or loss provided no money or other non-like-kind property is received by Taxpayer. If Taxpayer receives money or other non-like-kind property in an exchange, gain with respect to RQ transferred will be recognized in an amount not in excess of the sum of such money and the fair market value of such other non-like-kind property.

4. QI, acting in accordance with the Agreement, and if otherwise qualified, will be treated as a qualified intermediary as defined in Section 1.1031(k)-1(g)(4)(iii) and will be treated as acquiring and transferring each RQ and each RP for purposes of Section 1031.

5. Taxpayer will not be in actual or constructive receipt of money or other property from the disposition of RQ transferred in accordance with the Master Exchange Agreement (including any money or other property held in the Joint Accounts) unless and until Taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in the Joint Accounts mature as provided in the Master Exchange Agreement.
6. Taxpayer's participation in accordance with the Master Exchange Agreement in identifying sales proceeds from the disposition of RQ and in sorting those proceeds from other funds (including processing, depositing, and other handling of checks representing proceeds from disposition of RQ) does not result in actual or constructive receipt of money or other property from the disposition of RQ.

7. If Taxpayer's programs for financing purchases of its RQ (either on a separate rr note, a ww receivable, or as part of a dd wx) are at arm's length, with market rates and terms, and if Taxpayer promptly transfers funds equal to the loan proceeds to or for the benefit of QI, Taxpayer's receipt of the borrower's note or other evidence of indebtedness does not constitute actual or constructive receipt of money or other property from the disposition of RQ.

8. With respect to RQ that is purchased by the lessee, Taxpayer's application of the lessee's lease security deposit against the purchase price of RQ does not constitute actual or constructive receipt of money or other property from the disposition of RQ, provided that such applications of security deposits occur promptly and are in accordance with either the lessee's specific instructions or with the terms of the sales agreement between Taxpayer and lessee.

Under the Master Exchange Agreement, only mx acquired from dd qualify as replacement mx in Taxpayer's LKE Program. Since the inception of the LKE Program, the number of mx that Taxpayer purchases from dd has declined. As a consequence, Taxpayer does not acquire sufficient replacement mx to match all of its relinquished mx.

B. Proposed Modification of LKE Program

Taxpayer has an opportunity to acquire additional replacement mx *** Taxpayer can acquire additional replacement mx for its LKE Program.
To include the *** mx that Taxpayer will acquire *** as replacement mx in its LKE Program, Taxpayer and QI amended the master exchange agreement as follows:

1. to amend the definition of Acquisition Contract to include the rights of Taxpayer under the *** transactions to acquire *** the *** mx *** such that these rights will also be assigned to QI under the blanket assignment pursuant to section 4.1 of the master exchange agreement;

2. to provide for notification to the third parties, using the same language used for the notification of dd, of the assignment of Taxpayer's rights *** to QI on or prior to ***;

3. to provide that Taxpayer may make manual identifications of *** mx with respect to relinquished mx that are transferred during the 180-day period prior to ***; and

4. to amend the master exchange agreement to provide that, in a case where a manual identification of replacement mx has been made with respect to a relinquished mx, the LKE disposition proceeds relating to the relinquished mx can be released only after the expiration of the exchange period for that relinquished mx.

Taxpayer will begin to accumulate LKE disposition proceeds from relinquished mx disposed of on or before *** as QI funds for the purchase of *** mx. Such accumulated QI funds will not be used during the period prior to *** to purchase newly originated replacement mx from dd. Instead, during this period, Taxpayer will advance its own funds to purchase any newly originated replacement mx. Thus, upon execution of the amendment to the master exchange agreement, the LKE Program will include as replacement mx not only leased mx originated by dd, but also *** mx acquired ***. In addition, Taxpayer will have the right, during the 180-day period preceding ***, to manually identify *** mx as replacement mx. Thus *** will expand the pool of replacement mx against which relinquished mx transferred during the requisite time frame may be matched.

Taxpayer will make manual identifications of the *** mx by delivering to QI written documentation identifying by make, model and year three *** mx for each relinquished mx. Such documentation will be delivered semi-monthly. Taxpayer will also continue to acquire newly originated replacement mx from dd on and after the effective date of the amendment to the master exchange agreement. Taxpayer will match each relinquished mx with either (i) replacement mx acquired within 45 days of the date the relinquished mx was transferred, or (ii) replacement mx manually identified within 45 days of the date the relinquished mx was transferred and acquired within the exchange period.

LAW AND ANALYSIS

Section 1031(a)(1) generally provides 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(a)(3) provides that for purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if –

(A) such 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) such 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)(1) provides, in part, that replacement property is identified before the end of the identification period only if certain requirements are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

Section 1.1031(k)-1(c)(3) provides, in part, that replacement property is identified only if it is unambiguously described in the written document or agreement. Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model, and year.

Section 1.1031(k)-1(c)(4)(i) provides that a taxpayer may identify more than one replacement property. Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is –

(A) Three properties without regard to the fair market values of the properties (the "3- property rule"), or

(B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the "200-percent rule").

Section 1.1031(k)-1(g)(4)(iii) provides that a qualified intermediary is a person who –

(A) Is not the taxpayer or a disqualified person (as defined in Section 1.1031(k)-1(k)), and

(B) Enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(4)(iv) provides, in part, that, regardless of whether an intermediary acquires and transfers property, under general tax principles an intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

Section 1.1031(k)-1(g)(4)(v) provides that an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

CONCLUSION:

Under the facts presented here, the only substantial new feature added to Taxpayer's LKE Program is the new source for acquisition of mx as RP, ***. In addition, Taxpayer states that for mx acquired from this source, it will identify RP manually in accordance with the procedures outlined in Section 1.031(k)- 1(c) rather than rely exclusively on deemed identification by acquiring the RP within the 45-day identification period as permitted in the last sentence of Section 1.1031(k)-1(c)(1).

Furthermore, Taxpayer will assign to QI its rights *** to acquire *** the *** mx, and all required notices of this blanket assignment will be given. This is in substantial conformity to the requirements outlined in Section 1.1031(k)- 1(g)(4)(iii), (iv) and (v) that treat a qualified intermediary as receiving and transferring replacement property if the rights of the taxpayer to acquire replacement property are assigned to the intermediary and all parties to the agreement are so notified.

The amendments to the master exchange agreement do not affect Taxpayer's LKE Program insofar as the application of Section 1031 is concerned. The fact that replacement mx is derived from a different source ***, will not cause immediate recognition of gain from these transactions.

Similarly, manual identification complying with the methods of identification prescribed in the applicable regulations will not change the tax treatment of these items.

Accordingly, the modifications and additions to the LKE Program and the Master Exchange Agreement described above do not affect the analysis, conclusions and rulings set forth in the original ruling letter. Taxpayer may continue to rely upon those rulings notwithstanding the aforementioned modifications and additions.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under Section 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative(s).

Sincerely,

Robert A. Berkovsky
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200327039

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: July 3, 2003
March 27, 2003

Section 1031 -- Exchange of Property Held for Productive Use or Investment

LEGEND

Taxpayer =
Class1 =
Class2 =
Category A =
Category B =
Category C =
Category D =
Subsector xx =
State A =
Bank A =
Bank B =
City C =
Local Account =
The QI =
QI Administrator =
mx =
dd =
wx =
Ee =
Ff =

Dear ***:

This responds to your letter, dated August 16, 2002, requesting rulings on the proper federal income tax treatment of certain exchanges of personal property under Taxpayer's Like-Kind Exchange Program (LKE Program).

APPLICABLE FACTS:

Background Information.

Taxpayer is a State A corporation whose businesses include the buying, selling and leasing of mx. Taxpayer purchases leases and the related leased mx from dd with whom it has dd agreements in place (Ee). It derives income from receiving and processing lease payments as a lessor and providing other services incidental to the mx leasing business.

Taxpayer also realizes gain from dispositions of leased mx as the leases terminate. A lease terminates when, for example, the lease term expires; the leased mx is damaged beyond repair; the lessee defaults on the lease and the leased mx is repossessed; or the lessee purchases the leased mx prior to the expiration of the lease term. Methods of disposition of leased mx include:

1. Scope of Taxpayer's LKE Program.

Taxpayer plans to implement its LKE Program under Section 1031 of the Internal Revenue Code and the Income Tax Regulations thereunder with respect to many of its dispositions and acquisitions of leased mx. The LKE Program will involve most of the leased mx acquired and disposed of by Taxpayer's subsidiaries. Leased mx for which most or all of the disposition proceeds are insurance proceeds will be excluded from the LKE Program. Leased mx will be designated automatically for inclusion in the LKE program according to a predetermined set of LKE Program parameters. Taxpayer will be allowed to change these parameters from time to time, but only on a prospective basis. The initial parameters will be set forth in writing and may include basic criteria, such as make and model, as well as other criteria designed to fit within Taxpayer's financing arrangements and other circumstances. Leased mx meeting the LKE Program parameters that are disposed of pursuant to the LKE Program constitute "Relinquished Property" (RQ). Leased mx meeting the LKE Program parameters that are acquired pursuant to the LKE Program constitute "Replacement Property" (RP).

2. The Qualified Intermediary.

Taxpayer and its subsidiaries holding title to leased mx will enter into a Master Exchange Agreement with a party intended to qualify and function as a qualified intermediary within the meaning of Section 1.1031(k)-1(g)(4) of the regulations (the QI). The QI will function as an intermediary to facilitate exchanges of the leased mx designated for inclusion in the LKE Program. In the Master Exchange Agreement, Taxpayer will assign to the QI Taxpayer's rights (but not its obligations) under the contracts entered into by Taxpayer with respect to the disposition of RQ, and QI will use

proceeds from the disposition of RQ to pay the purchase price with respect to leased mx purchased from "Ee" pursuant to the LKE Program. The Master Exchange Agreement is intended to qualify as a written exchange agreement described in Section 1.1031(k)- 1(g)(4)(iii)(B).

The QI will be a newly formed, wholly owned subsidiary of an entity (the "QI Administrator") that Taxpayer selects to oversee the QI functions associated with the LKE Program. QI will be a limited liability company that will not elect to be treated as an association or corporation. The QI Administrator will be a wholly owned subsidiary of a bank within the meaning of Â§ 581. The principal activity of both the QI and the QI Administrator will be rendering services to facilitate exchanges of property intended to qualify for nonrecognition of gain under Section 1031. The QI Administrator also will be a party to the Master Exchange Agreement.

In the two years preceding the inception of the LKE Program, neither the QI nor the QI Administrator has acted as Taxpayer's employee, attorney, accountant, real estate agent or broker, or investment banker or broker. In fact, neither the QI nor the QI Administrator has performed any services in the past two years for Taxpayer. Further, while acting as Taxpayer's qualified intermediary, neither the QI nor the QI Administrator will perform any services for Taxpayer other than permitted, nondisqualifying services described in Section 1.1031(k)-1(k)(2)(i) and (ii).

None of the affiliates of either the QI or the QI Administrator has, in the past two years, performed services for Taxpayer. Further, none of the affiliates of either the QI or the QI Administrator will perform any services for Taxpayer or its affiliates while QI is acting as Taxpayer's qualified intermediary, other than those permitted under Section 1.1031(k)-1(k)(2) and investment banking or brokerage services permitted under Section 1.1031(k)- 1(k)(4)(ii).

Taxpayer will structure its LKE Program to meet the requirements of the "qualified intermediary" safe harbor under Section 1.1031(k)-1(g)(4), including the assignment and notice requirements.

3. Assignment and Notification Procedures for RQ.

Pursuant to the Master Exchange Agreement, Taxpayer will make a blanket assignment to the QI of Taxpayer's rights (but not its obligations) under contracts entered into by Taxpayer with respect to the disposition of RQ. Under the Master Exchange Agreement, such assignment will become effective automatically with respect to any RQ immediately prior to the disposition of such RQ. The assignment will apply to rights with respect to the portfolio of leased mx held by Taxpayer's subsidiaries on the date of execution of the Master Exchange Agreement, as well as to leased mx acquired by Taxpayer in the future. Taxpayer will provide the QI a list of RQ to be sold under sales contracts assigned to the QI.

Before the inception of the LKE Program, Taxpayer will send to all Ee a bulletin outlining the LKE Program (the "Dd Bulletin"). The Dd Bulletin will include a notice to the effect that Taxpayer has assigned to the QI all of its rights (but not its obligations) under contracts entered into by Taxpayer with respect to the disposition of RQ. The Dd Bulletin will further provide a payment procedure for all acquisitions and dispositions. Dd will be directed to make all checks payable to the QI and to direct all wire transfers and ACH payments to the Local Account, which will be a joint QI/Taxpayer account. New Ee will receive notification via ***.

In the case of leased mx disposed of by ***, Taxpayer will also provide blanket notification to purchasers by adding notification language to ***. Similarly, in the case of leased mx disposed of through the ***, Taxpayer will provide blanket notification to purchasers by adding notification language to the ***. The notifications contained in *** will be substantially to the effect that Taxpayer has assigned to QI all of Taxpayer's rights (but not its obligations) arising under contracts entered into by Taxpayer with respect to the disposition of RQ.

In most cases, Taxpayer will also provide purchasers of RQ with transaction-specific notice of its assignment to the QI of Taxpayer's rights (but not its obligations) under contracts entered into by Taxpayer in respect to the disposition of RQ. Each such notification will, in effect, be as follows:

You are hereby notified that all of [Taxpayer's] rights (but not its obligations) under the contract entered into by [Taxpayer] with respect to the disposition of the within-named [mx], have been assigned to the QI, acting as qualified intermediary, pursuant to the Master Exchange Agreement.

The manner in which such notice is delivered to a purchaser of RQ in *** or other forms of disposition will depend on the disposition method. For mx sold ***, Taxpayer will ***. In situations arising from *** from Taxpayer for specific mx, notification language will be included ***.

Taxpayer will provide *** with transaction specific notice at the inception of the LKE Program by adding notification language to *** prior to the inception of the program. Notification will be sent to *** under leases arising after the inception of the LKE program via ***. Taxpayer will also provide transaction-specific notice to *** who acquire leased mx pursuant to *** before the purchase.

Taxpayer will also provide transaction-specific notice to dd purchasers by adding the notice language to ***. In other instances where appropriate to ***, notice language will be added to *** to purchasers.

4. Assignment and Notification Procedures for RP.

As with RQ, Taxpayer will make a blanket assignment to the QI in the Master Exchange Agreement of Taxpayer's rights (but not its obligations) under contracts entered into by Taxpayer with respect to the acquisition from Ee of RP. Under the Master Exchange Agreement, the assignment will become effective automatically for any RP prior to the acquisition of such RP. Taxpayer will provide the QI a list of RP to be acquired under purchase agreements assigned to the QI.

Taxpayer will also provide blanket notification to all Ee, before the inception of the LKE Program, by including in the Dd Bulletin additional language to the effect that Taxpayer has assigned to the QI all of Taxpayer's rights (but not its obligations) under the contracts entered into by Taxpayer with respect to its acquisition of RP. New Ee will receive notification by means of language included in ***.

In addition to the blanket notification, Taxpayer will also notify Ee from whom it acquires RP on a transaction-specific basis by means of notification language added to the *** for each leased mx purchased. The notice language will be to the following effect:

You are hereby notified that all of the rights of [Taxpayer] (but not its obligations) under the contract entered into by [Taxpayer] with respect to its acquisition of the within referenced [mx] (if and at such time as such a contract arises) have been assigned to QI acting as qualified intermediary, pursuant to the Master Exchange Agreement.

5. LKE Program Cash Flow and Bank Account Structure.

The Master Exchange Agreement sets forth the bank account structure to be maintained by the QI and Taxpayer with respect to the LKE Program. Taxpayer already maintains the Local Account at Bank A and the Outflow Accounts at Bank B. In connection with the LKE Program, Taxpayer will establish a new joint QI/Taxpayer account at a third entity, which is an affiliate of the QI Administrator (or "Joint Concentration Account"). The Joint Concentration Account and the Local Account will constitute the "Inflow Accounts." Taxpayer and the QI will enter into a separate agreement with each of the three different financial institutions (Bank A, Bank B and QI Administrator (which is a bank subsidiary)) with respect to each of the Inflow Accounts and the Outflow Accounts (collectively, the Joint Accounts), governing all funds received in respect of any leases or leased mx and with respect to funds held for the purchase of newly originated leases and related leased mx.

Under the LKE Program, all purchasers will be instructed to make checks payable to the QI, and to direct ACH or wire transfer payments to the Joint Local Account. With respect to disbursements under the LKE Program, the purchase price for a lease and the related leased mx, will be paid from the Outflow Accounts. If such mx constitutes RP, the purchase price will be paid from amounts held for the benefit of the QI ("QI Funds"). All other payments from the Outflow Accounts will be paid from amounts held for the benefit of Taxpayer ("[Taxpayer] funds").

As funds are received in the Joint Accounts, they will be identified as QI Funds, Taxpayer Funds or Unidentified Funds. Unidentified Funds will be redesignated as QI Funds or Taxpayer Funds as they are identified.

Under each joint account agreement, all funds representing disposition proceeds of RQ (consisting of disposition proceeds less costs of sale and related expenses), and any other amounts designated as funds held for the benefit of the QI pursuant to the Master Exchange Agreement, including Taxpayer funds that are redesignated as QI Funds and investment earnings on funds on deposit in the Joint Accounts, shall be held for the benefit of the QI. All other funds, other than Unidentified Funds, will be held for the benefit of Taxpayer.

Under the terms of the Master Exchange Agreement and the joint account agreements, QI Funds may be applied only to purchase RP. QI Funds may not be used to purchase any other property or for any other purpose except where QI Funds are redesignated as Taxpayer Funds pursuant to a Ff).

The Ff is used to monitor the transfer of collections and obtain Taxpayer's and the QI's authorization for disbursement funding. The report specifies how much is needed to fund purchases of RP, the amount of additional funds (if any) needed from Taxpayer for purchases of RP, and the amount of funds needed from Taxpayer for non-LKE disbursements. The report also states the total receipts received into the Joint Concentration Account, the amount of QI Funds, the amount of Unidentified Funds, the amount of Taxpayer funds, and the amount of non-like-kind exchange proceeds in the Joint Concentration Account that are to be transferred to the ACH loan account or to a Taxpayer account. Representatives of both the QI and Taxpayer must authorize transfers before they occur. As provided in the Master Exchange Agreement, no funds can move out of the Outflow Accounts without the QI's authorization.

Funds in the Joint Local Account will be *** into the Joint Concentration Account ***. Under the Master Exchange Agreement and each joint account agreement, funds may be moved out of the Joint Concentration Account to an Outflow Account, an account controlled by Taxpayer, or to a collection account or other account relating to a Taxpayer financing arrangement only with the joint approval of the QI and Taxpayer. To obtain approval, Taxpayer will send to the QI a Ff each day. Taxpayer will provide its authorization by having a Taxpayer representative sign the report. The QI will review the report and provide authorization by having a QI representative sign the report and provide it to the bank, thereby allowing funds to move.

All funds held in the Joint Accounts at the end of each day will be invested in accordance with Taxpayer's instructions. Any income earned on these funds will be reported by Taxpayer for tax purposes. The earnings on all funds will be designated as QI Funds held for the benefit of the QI and, like LKE disposition proceeds, may be used solely to acquire RP in the future.

All funds constituting LKE disposition proceeds will be held for the benefit of the QI. Taxpayer will act as the servicer under the LKE Program to open envelopes and process and deposit checks into the Joint Local Account. Taxpayer begins the process of sorting and identifying LKE disposition proceeds and non-LKE disposition proceeds as payments are posted to Taxpayer's information system.

Disbursements for the acquisition of all leases and the related leased mx (without regard to whether the leased mx are RP) and for acquisition of *** will be made through the Outflow Accounts. Thus, the Outflow Accounts will continue to serve as a cash clearinghouse for all such disbursements by Taxpayer, enabling Taxpayer to issue a single payment to an Ee for all of Taxpayer's acquisitions from that Ee. To the extent the amount of QI funds in the Joint Accounts is insufficient to fund the acquisition of RP, Taxpayer will make up any shortfall.

Certain transactions involving RQ and/or RP require adjustments to the amounts in the QI funds and Taxpayer funds held in the Joint Accounts. Each of these transactions and the necessary adjustments are discussed below in further detail.

A. Application of Lease Security Deposit to *** Purchases. Under the agreements pursuant to which Taxpayer acts as servicer for the ***, Taxpayer holds lessee security deposits, to be applied upon lessee default or termination of the lease. If a lessee decides to purchase a leased mx, at or prior to

the expiration of the lease term, the lessee can instruct Taxpayer to apply all or part of the remaining security deposit (after application against lease termination charges) against the purchase price of the leased mx. This is possible for ***.

In the case of a leased mx constituting RQ, the lease security deposit applied by Taxpayer against the purchase price constitutes a part of the LKE disposition proceeds for such RQ. As a result, Taxpayer and the QI will be required under the Master Exchange Agreement and the joint account agreement to notify the bank of such adjustment in the Ff. The amount of Taxpayer funds in the Joint Accounts will be reduced and the amount of QI Funds in the Joint Accounts will be increased by the amount of the lease security deposit so applied.

B. Application of Lease Security Deposit to Taxpayer Purchase from Dd. In the case of a newly originated leased mx, an Ee may receive a security deposit from the lessee. When Taxpayer purchases a leased mx from an Ee, Taxpayer funds the purchase net of the security deposit and assumes the obligation to repay the security deposit upon the termination of the lease.

Where the security deposit received by the Ee is applied against the purchase price of a leased mx that constitutes RP, the security deposit is part of the purchase price obligation the QI owes the Ee. In order for the QI to expend the full amount of the purchase price for RP under the Master Exchange Agreement, QI funds in an equal amount to the security deposit will be redesignated as Taxpayer funds by means of the Ff.

C. *** Transactions. In the normal course of its business, Taxpayer provides *** financing to ***. In such *** transactions, Taxpayer obtains the purchaser's note in a separate transaction from the disposition of the leased mx. In the case of a leased mx constituting RQ, either Taxpayer will forward to the QI the financed amount representing the LKE disposition proceeds, or an adjustment will be made in the Ff redesignating Taxpayer funds in the financed amount as the QI funds.

D. Taxpayer-Financed Dd Purchases. Taxpayer also provides financing to dd under its wx financing program. Under this program, dd may finance *** purchases as well as purchases through other disposition channels. In the case of ***, actual cash transfers are made with respect to the disposition proceeds and amounts financed. Under the LKE Program, the disposition proceeds will be made payable to the QI, while the amounts financed will be separately transferred by Taxpayer. Therefore, no adjustments will be necessary when dd finance *** purchases under Taxpayer's wx financing program.

Where Taxpayer finances dd purchases in other disposition channels (i.e., ***, etc.), no actual cash transfers occur. Instead, a dd makes a *** from Taxpayer by making a draw under its wx financing arrangement with Taxpayer and Taxpayer sets up a *** receivable with respect to the transaction. In the case of a purchase of a leased mx constituting RQ, either Taxpayer will forward to the QI the financed amount representing LKE disposition proceeds, or an adjustment will be made in the Ff redesignating Taxpayer funds in the financed amount as the QI funds.

Alternatively, in some instances, LKE disposition proceeds will actually flow from the dd to the Joint Local Account, and the amount financed will be separately transferred from Taxpayer to the dd. This occurs in two separate transactions: First, the dd pays off the mx by check or ACH transfer, and second, Taxpayer separately transfers the financed amount to the dd, typically by ACH. In such a transaction, a dd that participates in Taxpayer's wx financing program purchases RQ by adding the mx to its wx arrangement.

E. ***

6. Non-LKE Transaction Processing.

All disbursements and collections relating to leases and the related leased mx, including leased mx that are not RQ or RP in an LKE transaction, will flow through the Inflow and Outflow Accounts. However, pursuant to the Master Exchange Agreement and each joint account agreement, non-LKE disbursements will be funded solely from Taxpayer funds.

7. Legal Agreements Governing Cash Flows.

The Master Exchange Agreement and the joint account agreements provide that Taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held as Unidentified Funds at any time or as QI Funds with respect to any exchange, before the occurrence of a circumstance listed in Section 1.1031(k)-1(g)(6).

8. Matching.

As part of the LKE transaction, LKE disposition proceeds will flow through the LKE account structure and be used to acquire RP. Information about RQ and RP will be analyzed by a computer algorithm to match RQ with RP for which it was exchanged according to certain parameters designed primarily to maximize the benefits of the LKE Program. For example, RQ will be matched only with RP acquired within 45 days of the date RQ was transferred to its purchaser and, to the extent possible, RQ will be matched with RP costing at least as much as the RQ.

In the LKE transactions that will occur under this system, Taxpayer proposes to classify exchange property consisting of Category A, Category B, and Category C as belonging to Class1 and exchange property consisting of Category B, and Category C, and Category D as belonging to Class2. RQ in Class1 will be matched only with RP in Class1 and RQ in Class2 will be matched only with RP in Class2.

APPLICATION OF LAW TO FACTS:

Section 1031(a)(1) 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 that is to be held either for productive use in a trade or business or for

investment. Thus, for a transaction to qualify as an exchange under Section 1031, the exchanged properties must be of a like kind and held for productive use in a trade or business or for investment.

Ruling Request Number 1:

Taxpayer requests a ruling that properties described as being within Category A, Category B and Category C (which Taxpayer groups into Class1) are of like kind and properties described as being within Category B, Category C and Category D (which Taxpayer groups into Class2) are of like kind.

The requirement that the exchanged properties be of like kind has reference to the nature or character of the property and not to its grade or quality. Section 1.1031(a)-1(b). To qualify for like-kind exchange treatment, one kind or class of property may not be exchanged for property of a different kind or class. Depreciable tangible personal properties are of a like class if they are either within the same General Asset Class, as defined in Section 1.1031(a)- 2(b)(2), or within the same Product Class, as defined in Section 1.1031(a)- 2(b)(3). If a property is classified within any General Asset Class, it may not be classified within a Product Class. Section 1.1031(a)-2(b)(1).

Section 1.1031(a)-2(b)(2) describes the various General Asset Classes. The regulations specifically provide that property in Category A is within Class1 and property in Category D is within Class2. The regulations do not specify Category B or Category C property as belonging to either Class1 or Class2. See also Rev. Proc. 87-56, 1987-2 C.B. 674. However, Section 1.1031(a)- 2(b)(3), as updated pursuant to Section 1.1031(a)-2(b)(4) and (5), provides for matching of property belonging to the same product class as specified under the classification code of the Standard Industrial Classification Manual (1987) ("SIC Manual"), now currently updated under the North American Industry Classification System (1997) ("NAICS Manual").

To the extent that each exchange consists of one or more RQ and one or more RP in the same General Asset Class or the same Product Class, these exchanges fit within the General Asset Class or the Product Class safe harbor described above. The General Asset Class and Product Class safe harbors in the regulations simplify the determination of whether depreciable tangible personal property is of a like kind. Under the Product Class safe harbor, according to Subsector xx of the NAICS Manual, property within Categories B, C and D are all of the same product class.

However, the General Asset Class and Product Class safe harbors are not the exclusive method for determining if exchange properties are of like-kind. For depreciable tangible personal property to be considered of like kind for purposes of Section 1031, the property can be either like kind or like class. Section 1.1031(a)-2(a) provides that "an exchange of properties of a like kind may qualify under Section 1031 regardless of whether the properties are also of like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class." Thus, two *** properties can be in different General Asset Classes (and thus not be of a like class) and yet be of like kind.

The like-kind standard has been interpreted more narrowly in the case of exchanges of personal property as compared to exchanges of real property. See California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982) (Tax Court did not err in refusing to apply the lenient treatment of real estate exchanges to an exchange of personal property involving U.S. Double Eagle $20 gold coins and Swiss francs). Even within the more restrictive parameters of the like-kind standard as applied to personal property, the differences between property in Category A, Category B and Category C do not rise to the level of a difference in nature or character but are merely a difference in grade or quality.

Therefore, properties described as belonging to Categories A, B and C are of like-kind even if they do not belong to the same general asset class. Also, properties in Categories B, C and D are of like kind or like class because they are within the same Product Class.

Ruling Request No. 2:
Taxpayer requests a ruling that its transfer of each RQ, or group of RQ, and the corresponding receipt of RP, or group of RP, in accordance with the Master Exchange Agreement will be treated as a separate and distinct exchange for purposes of Section 1031.

Taxpayers are allowed great latitude in structuring transactions under Section 1031. Biggs v. Commissioner, 69 T.C. 905, 913 (1978). Moreover, the regulations governing exchanges of multiple properties require such groupings when taxpayers exchange multiple properties. For example, Section 1.1031(j)- 1(a)(2)(i) generally provides that the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received by the taxpayer in the exchange into exchange groups.

If an exchanger is complying with all requirements under the Code and regulations for exchanging property under Section 1031, any reasonable arrangement of like-kind properties into exchange groups as relinquished or replacement property for separate transactions, consistent with the regulations, should be respected. In the case of an LKE Program, a taxpayer's transfer of each RQ, or group of RQ, and the taxpayer's corresponding receipt of each RP, or group of RP, with which such RQ, or group of RQ, has been matched by the taxpayer is treated as a separate and distinct exchange for purposes of Section 1031. The determination of whether a particular exchange qualifies under Section 1031 will be made without regard to any other exchange. Thus, if a particular exchange of RQ, or group of RQ, for an RP, or group of RP, pursuant to an LKE Program fails to qualify under Section 1031, such failure will not affect the application of Section 1031 to any other exchange pursuant to such LKE Program.

Therefore, Taxpayer's transfer of each RQ, or group of RQ, and the corresponding receipt of RP, or group of RP, in accordance with the Master Exchange Agreement will be treated as a separate and distinct exchange for purposes of Section 1031.

Ruling Request No. 3:

Taxpayer requests a ruling that each exchange, in accordance with the Master Exchange Agreement, of one or more RQ for one or more RP will qualify for nonrecognition of gain or loss provided no money or other non-like-kind property is received by Taxpayer. If Taxpayer does receive money or other non-like-kind property in an exchange, gain with respect to RQ transferred will be recognized in an amount not in excess of the sum of such money and the fair market value of such other non-likekind property.

Section 1031(b) provides that if an exchange would be within the provisions of Section 1031(a) if it were not for the fact that the property received in the exchange consists not only of property permitted by such section to be received without recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1.1031(k)-1(f)(1) generally provides that a transfer of relinquished property in a deferred exchange is not within the provisions of Section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either Section 1031 (b) or (c). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides, in part, that except as provided in Section 1.1031(k)-1(g) (relating to safe harbors), for purposes of Section 1031 and Section 1.1031(k)-1, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to Section 1.1031(k)-1(k)) is actual or constructive receipt by the taxpayer.

Section 1.1031(k)-1(g)(2) through (g)(5) sets forth a variety of safe harbors for use in deferred exchange situations. The use of one or more of these safe harbors in a deferred exchange will shield a taxpayer from actual or constructive receipt of money or other property. In the present case, Taxpayer will use the qualified intermediary safe harbor as described in Section 1.1031(k)- 1(g)(4). Section 1.1031(k)-1(g)(4)(i) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a). In such a transaction, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Section 1.1031(k)-1(g)(4)(ii) states that the qualified intermediary safe harbor applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

In the present case, Taxpayer is entering into a Master Exchange Agreement with an accommodator represented to meet all the prerequisites to be a qualified intermediary. Taxpayer further represents that the agreement contains all restrictions necessary to qualify the planned deferred exchanges as tax deferred exchanges under Section 1.1031(k)-1.

Therefore, each exchange in accordance with the Master Exchange Agreement of one or more RQ transferred for one or more RP will qualify for nonrecognition of gain or loss provided no money or other non-like-kind property is received by Taxpayer. If Taxpayer receives money or other non-like-kind property in an exchange, gain with respect to RQ transferred will be recognized in an amount not in excess of the sum of such money and the fair market value of such other non-like-kind property.

Ruling Request No. 4:

Taxpayer requests a ruling that QI, acting in accordance with the Master Exchange Agreement, be treated as a qualified intermediary as defined in Section 1.1031(k)-1(g)(4) and be treated as acquiring and transferring each RQ and each RP for purposes of Section 1031.

Section 1.1031(k)-1(g)(4)(iii) defines the term "qualified intermediary" as a person, not the taxpayer or a disqualified person (as defined in Section 1.1031(k)-1(k)), who enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Regardless of whether an intermediary acquires and transfers property under general tax principles, an intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person, and pursuant to that agreement, the relinquished property is transferred to that person. See Section 1.1031(k)- 1(g)(4)(iv)(B). An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer. Section 1.1031(k)-1(g)(4)(iv)(C). For these purposes, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. See Section 1.1031(k)-1(g)(4)(v).

In the instant case, Taxpayer has assigned to QI its rights to sell RQ. In all instances, the purchaser receives notice of the assignment prior to the time that the RQ is transferred to the purchaser. Each form of notice informs the purchaser in writing that Taxpayer has assigned to QI its rights to sell RQ. Title to RQ will be transferred directly from Taxpayer to the purchaser of RQ pursuant to the agreement between Taxpayer and purchaser. Thus, QI will be treated as acquiring and transferring RQ. See Section 1.1031(k)-1(g)(4)(iv)(B) and (v).

In addition, Taxpayer assigned its right to purchase RP to QI. In all instances, the seller receives notice prior to the transfer of RP to Taxpayer. Each form of notice informs the seller in writing that Taxpayer has assigned to QI its rights to purchase RP. RP is transferred directly to Taxpayer pursuant to the agreement between seller and Taxpayer. Thus, QI will be treated as acquiring and transferring RP. See Section 1.1031(k)-1(g)(4)(iv)(C) and (v).

Accordingly, QI, acting in accordance with the Agreement, and if otherwise qualified, will be treated as a qualified intermediary as defined in Section 1.1031(k)-1(g)(4)(iii) and will be treated as acquiring and transferring each RQ and each RP for purposes of Section 1031.

Ruling Request No. 5:

Taxpayer requests a ruling that Taxpayer will not be in actual or constructive receipt of money or other property from the disposition of RQ transferred in accordance with the Master Exchange Agreement (including any money or other property held in the Joint Accounts) unless and until such money or other property is actually transferred directly to Taxpayer or to an account solely in the name of Taxpayer.

Proceeds from the sale of RQ are deposited into a joint bank account belonging to Taxpayer and QI (the Joint Accounts). Similarly, Taxpayer's agreements provide that amounts collected from *** are deposited into accounts specified by the QI and Taxpayer (the Joint Accounts). Taxpayer is not in actual or constructive receipt of proceeds of sales of RQ that are deposited in the Joint Accounts, and ultimately used to acquire RP. The Master Exchange Agreement and the joint account agreements also provide that no funds can be withdrawn without QI approval. These agreements restrict, as required by Section 1.1031(k)-1(g)(4)(ii) and (g)(6)(i), Taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of RQ proceeds and earnings thereon, that are held in the Joint Accounts until the expiration of the periods described. The Master Exchange Agreement and joint account agreements provide that QI has first priority to those funds in the Joint Accounts which are the full amount of proceeds from sales of RQ. To the extent that funds from the sale of RQ are insufficient to cover the purchase of RP, Taxpayer transfers funds to cover the amount of the purchases. Therefore, Taxpayer will not be in actual or constructive receipt of money or other property from the disposition of RQ transferred in accordance with the Master Exchange Agreement (including any money or other property held in the Joint Accounts) unless and until Taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in the Joint Accounts mature as provided in the Master Exchange Agreement.

Ruling Request No. 6:

Taxpayer requests a ruling that Taxpayer's participation in accordance with the Master Exchange Agreement in identifying sales proceeds from the disposition of RQ and in sorting those proceeds from other funds (including processing, depositing, and other handling of checks representing proceeds from disposition of RQ) does not result in actual or constructive receipt of money or other property from the disposition of RQ.

Section 1.1031(k)-1(f)(2) provides, in part, that a taxpayer is in actual receipt at the time the taxpayer actually receives money or property or receives the economic benefit of the money or property. It also provides that a taxpayer is not in constructive receipt if the taxpayer's control over the money or property is subject to substantial limitations or restrictions, but is in constructive receipt at the time the limitations or restrictions lapse, expire, or are waived. Thus, a taxpayer is considered to have constructive receipt if the money or property is credited to the taxpayer's account, set apart for the taxpayer or otherwise made available so that the taxpayer may draw on it at any time or when notice of intention to draw upon it is given.

An important function performed by taxpayers in the leasing business is the day to day processing of leases and other payments called for under the lease agreements. In its capacity as a "servicer," Taxpayer opens envelopes from lessees, deposits checks, and records payments to lessees' accounts. Taxpayer may also process numerous other kinds of payments related to its leasing business (e.g., ***, etc.). In addition, Taxpayer may also process payments in connection with other lines of business in which Taxpayer is engaged. Business realities may require that all payments be sent to one or more central locations for processing and sorting.

In the course of its operations, Taxpayer will receive *** for RQ. These checks, which are payable to the QI, but delivered to Taxpayer, are deposited by Taxpayer into Local Account (one of the Joint Accounts of Taxpayer and QI) after Taxpayer performs bookkeeping and recording tasks with respect to payments which constitute LKE disposition proceeds.

Taxpayer will have assigned to QI its rights to the disposition proceeds under the contracts for the sale of RQ. Prior to the sale of any RQ, purchasers will have been notified to make all checks payable to QI. Taxpayer's receipt and handling as servicer of checks made payable to another party do not constitute actual or constructive receipt of such checks, because Taxpayer has no right to negotiate the check or deposit it (or any other form of payment) into a separate account of Taxpayer. See UCC Sections 3-110 and 3-420 (respectively pertaining to the negotiation and conversion of negotiable instruments).

Therefore, Taxpayer's participation in accordance with the Master Exchange Agreement in identifying sales proceeds from the disposition of RQ and in sorting those proceeds from other funds (including processing, depositing, and other handling of checks representing proceeds from disposition of RQ) does not result in actual or constructive receipt of money or other property from the disposition of RQ.

Ruling Request No. 7:

Taxpayer requests a ruling that for the purchases of RQ financed by Taxpayer (either as a separate *** note, a *** receivable, or as part of a dd wx), Taxpayer's receipt of the borrower's note or other evidence of indebtedness does not constitute actual or constructive receipt of money or other property from the disposition of RQ.

In the ordinary course of its business, Taxpayer provides financing to dd and individuals. Dd and other purchasers of Taxpayer's leased mx are under no obligation to finance purchases with Taxpayer and are free to obtain financing from other financial institutions. Taxpayer's provision of *** financing to *** and the application of a lessee's lease security deposit constitute separate and distinct arm's length transactions from the lessee's purchase of a mx. When Taxpayer receives a note evidencing an amount that it is financing, Taxpayer records the note in a wholly separate transaction from that in which the amount financed is recorded. Similarly, Taxpayer's provision of wx financing to dd is recorded in a wholly separate transaction from the disposition of the leased mx.

A taxpayer may advance money toward the purchase of property to be acquired by exchange. See 124 Front Street v. Commissioner, 65 T.C. 6 (1975); Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980), aff'g 69 T.C.905 (1978). In an installment sale situation the term "payment" generally does not include the receipt of an evidence of indebtedness from the person acquiring the property. Section 15a.453-1(b)(3)(i).

Accordingly, if Taxpayer's programs for financing purchases of its RQ (either on a separate *** note, a *** receivable, or as part of a dd wx) are at arm's length, with market rates and terms, and if Taxpayer promptly transfers funds equal to the loan proceeds to or for the benefit of QI, Taxpayer's receipt of the borrower's note or other evidence of indebtedness does not constitute actual or constructive receipt of money or other property from the disposition of RQ.

Ruling Request No. 8:

Taxpayer requests a ruling that, for RQ purchased by the lessee of RQ, Taxpayer's application of the lessee's lease security deposit against the purchase price of RQ does not constitute actual or constructive receipt of money or other property from the disposition of RQ.

When Taxpayer sells a leased mx to a lessee, Taxpayer will apply all or part of the lessee's remaining lease security deposit (after application against lease termination charges) against the lessee's purchase price of the leased mx at the direction of the lessee. If the lessee does not direct Taxpayer to apply the remaining security deposit against the lessee's purchase price obligation, Taxpayer must return the security deposit to the lessee under the terms of the lease. If the lessee requests that its security deposit be applied against the purchase price of a leased mx that constitutes RQ, an amount of Taxpayer funds equal to the applied security deposit will be redesignated as QI funds in the Ff, so that QI receives the full amount of LKE disposition proceeds.

When Taxpayer purchases a leased mx from an Ee, the Ee may apply the security deposit received from the lessee against Taxpayer's purchase price obligation owed to the Ee. If the Ee applies the lessee's security deposit against the purchase price of a leased mx that constitutes RP, QI funds in an amount equal to the applied security deposit will be redesignated as Taxpayer funds in the Ff. The application of the security deposit against the purchase price obligation is merely for administrative convenience to the Ee. By redesignating QI funds as Taxpayer funds, in an amount equal to the security deposit, QI is simply expending the full purchase price for RP.

Rev. Rul. 72-519, 1972-2 C.B. 32, 33, states that in cases involving rental property, payments received by a lessor to secure the lessee's performance of covenants contained in a lease, and which are to be refunded at the expiration of the lease are not taxable income even though the lessor had use of the money. According to the revenue ruling, even if the parties may apply the security deposit against the purchase price of the rented property, the deposit will not be treated as a taxable advance payment if its primary purpose is to protect the lessor's title and interest and to guarantee faithful performance of the lease agreement. Under Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), a taxpayer lessor does not take the lessee's security deposit into income as long as its control and dominion over the deposit is incomplete and subject to conditions outside the control of the taxpayer. To the extent deposit funds are available to lessee as partial payment of the purchase price, they are funds belonging to the lessee.

Therefore, with respect to RQ that is purchased by the lessee, Taxpayer's application of the lessee's lease security deposit against the purchase price of RQ does not constitute actual or constructive receipt of money or other property from the disposition of RQ, provided that such applications of security deposits occur promptly and are in accordance with either the lessee's specific instructions or with the terms of the sales agreement between Taxpayer and lessee.

CAVEATS AND EXCEPTIONS:

Except as specifically provided above, no opinion is expressed as to the federal income tax treatment of the LKE Program and the transactions described under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income tax law. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, nor effects resulting from, the transactions that are not specifically covered by the above ruling. Finally, no opinion is expressed regarding whether the accommodators used in the LKE Program or the transactions described are disqualified persons, as defined in Section 1.1031(k)-1(k), because such determinations are factual. This ruling assumes that the QI and the QI Administrator are eligible under the regulations to serve as qualified intermediaries.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent. Pursuant to a Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representatives.

Sincerely yours,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200242009

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: October 18, 2002
July 3, 2002

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Parent =
Taxpayer =
QI =

Dear ***:

This letter responds to your request for a private letter ruling submitted on behalf of Taxpayer, requesting rulings on issues concerning its establishment of a like-kind exchange program under section 1031 of the Internal Revenue Code.

FACTS

Taxpayer is a wholly-owned subsidiary of a subsidiary which, in turn, is owned by Parent, a multi-state bank holding company.

Taxpayer is primarily engaged in the business of leasing vehicles to consumers and issuing loans to consumers for the purchase of vehicles. Taxpayer currently maintains a portfolio of vehicles leased to individual customers for non-commercial use. These vehicles are automobiles, passenger vans, light duty trucks, and sport utility vehicles ("SUVs"). Typically the leases range from twelve months to sixty-three months in duration. Taxpayer has legal title to each vehicle and depreciates each vehicle pursuant to section 168.

Taxpayer restructured its vehicle leasing operations with the intention that the disposition of a vehicle coming off lease (a relinquished vehicle) by Taxpayer to an unrelated party and the acquisition by Taxpayer of a vehicle recently leased from a dealer (a replacement vehicle) will qualify as a like-kind exchange under section 1031. Relinquished vehicles are typically sold to the dealer, the lessee, or a third party through an auction. Replacement vehicles are usually purchased from an unrelated dealer.

To meet the requirements of section 1031, Taxpayer entered into an agreement with QI (the Exchange Agreement), under which QI is to act as the qualified intermediary under section 1.1031(k)-1(g)(4) of the Income Tax Regulations. Accordingly, Taxpayer assigns its rights for the sale of relinquished vehicles and the purchase of replacement vehicles to QI.

QI is a corporation wholly owned by a third party that is unrelated to Taxpayer. QI has not previously performed services other than routine financial services for Taxpayer.

Under the Exchange Agreement, QI is to keep an escrow account and a disbursement account at a financial institution unrelated to Parent or Taxpayer. The escrow account is to hold the proceeds from relinquished vehicles, while the disbursement account, consisting of funds solely from the escrow account, is to pay for replacement vehicles. If the disbursement account does not contain a sufficient amount of funds to acquire replacement vehicles, Taxpayer will supply additional funds to the disbursement account to cover any deficiency.

The Exchange Agreement expressly limits Taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by QI before the end of the exchange period. For this purpose, the exchange period begins on the day of the sale of the relinquished vehicle and ends at midnight on the 45th day following the sale of a relinquished vehicle if no replacement vehicle is identified. If a replacement vehicle has been identified during the 45-day window, the exchange period will end the earlier of the 180th day following the sale of the relinquished vehicle or the date Taxpayer receives the replacement vehicle. The Exchange Agreement provides that Taxpayer has a right to receive money or other property held by QI prior to the end of the exchange period only upon the occurrence of an event described in section 1.1031(k)-1(g)(6)(ii) or (iii).

The Exchange Agreement authorizes QI to purchase all leased vehicles on Taxpayer's behalf, including vehicles that will not be replacement vehicles for purposes of a like-kind exchange. Periodically, Taxpayer will assign QI the right to sell all vehicles purchased by Taxpayer after the date of the Exchange Agreement. Non-replacement vehicles are purchased by QI and paid for out of the disbursement account in the same procedures applicable to replacement vehicle purchases. This is done because Taxpayer currently acquires more vehicles than are being relinquished and it matches each replacement vehicle with one relinquished vehicle for basis tracking purposes. The unmatched vehicles are non-replacement vehicles.

Sale of Relinquished Vehicles

The exchange transactions take place on completion of a lease term, or upon early termination of a lease. At such time, the vehicle will be offered to sale to the lessee, and if the lessee refuses, then to the dealer. The transactions are then carried out as follows.

In a typical transaction, the lessee of a vehicle decides to purchase the vehicle from Taxpayer. Consequently, the lessee contacts Taxpayer's customer service department to obtain the purchase price of the vehicle. During the time of the phone call, a customer service representative verbally notifies

the lessee that Taxpayer's rights to sell the vehicle have been assigned to QI. Additionally, this notification appears in the lessee's payment coupon booklet.

After receiving an offer from the lessee to purchase the vehicle, Taxpayer includes the vehicle's purchase price, lease numbers, and purchaser's name on a list that is then sent to QI. The list contains notification that the vehicles are being assigned from Taxpayer to QI.

The lessee will forward to Taxpayer a check made payable to QI. Taxpayer will receive the check in order to process the paperwork associated with the lease transaction. Since Taxpayer maintains the leases on its accounting system, Taxpayer will have all information necessary to ascertain whether the paperwork and check amounts are in order. Due to the volume of outstanding leases, these are significant tasks.

In some cases, the lessee purchases the vehicle using funds borrowed from one of the banking subsidiaries of Parent. This loan occurs in a separate arm's-length transaction After the loan agreement is executed, the banking subsidiary mails a check to Taxpayer. The check is made payable to the order of QI. Pursuant to the Exchange Agreement, Taxpayer forwards the check to QI for deposit into the escrow account. After QI has received the check, Taxpayer arranges to transfer title of the vehicle to the lessee.

Additionally, in some cases, the lessee elects to have the lease security deposit held by Taxpayer applied to the purchase of the vehicle. In those circumstances, Taxpayer will ask the lessee to request in writing that Taxpayer, as the lessee's agent, forward the security deposit to QI in satisfaction of part of the purchase price. Taxpayer, will make a check payable to QI for the amount of the security deposit and forward it along with the lessee's purchase check to QI.
Acquisition of Replacement Vehicles
Taxpayer acquires replacement vehicles pursuant to contracts Taxpayer has entered into with unrelated dealerships, in which Taxpayer agrees to purchase from the dealer each vehicle leased by the dealer under certain terms and conditions. Before the purchase transaction, Taxpayer sends each dealer a letter notifying the dealer that Taxpayer's rights to purchase a vehicle have been assigned to QI.

Under Taxpayer's leasing program, a lessee and a dealer complete a leasing application in which the lessee applies for a credit check. Next, the dealer notifies Taxpayer of the potential lease customer and the credit check. If the credit application is approved, Taxpayer begins to process the paperwork to acquire the vehicle, which includes notifying the QI of the purchase of the vehicle.

After the necessary paperwork has been completed by all parties to the transaction, the dealer will obtain payment for the vehicle by drawing on the disbursement account controlled by QI. Once a dealer has drafted on the disbursement account, the funds will be transferred directly from the disbursement account to the dealer's account. Title will be transferred to and in the name of Taxpayer.

Within 45 days of relinquishing a vehicle, Taxpayer matches the relinquished vehicle with one replacement vehicle.

REQUESTED RULINGS

1. Each transfer by Taxpayer of a relinquished vehicle and receipt of an identified replacement vehicle in accordance with the Exchange Agreement will constitute a separate and distinct like-kind exchange transaction that qualifies for deferral of gain recognition for federal income tax purposes pursuant to section 1031.

2. Taxpayer will not be in constructive receipt of any money or other property held by QI pursuant to section 1.1031-1(k)-1(f)(1) unless and until such items are actually payable to or received by Taxpayer, on the condition that the requirements of the Exchange Agreement, representations in this ruling request, and other conditions of the safe-harbor test are in fact met.

3. If a lessee elects to have the security deposit held by Taxpayer applied to the purchase of a vehicle, Taxpayer will not be in constructive receipt of the security deposit funds pursuant to section 1.1031(k)-1(f)(1).

4. The exchange pursuant to the Exchange Agreement of each relinquished vehicle for a properly identified and received replacement vehicle will constitute a nontaxable exchange to the extent no cash or other non-like-kind property as defined ins section 1031(b) is received in the exchange. If cash or other non-like-kind property is received in the exchange, any gain with respect to the relinquished vehicles will be recognized only to the extent of such cash or other property.

5. The role of QI in the purchase of vehicles that are not replacement property, and thus not involved in the like-kind exchange constitutes routine financial or trust services for Taxpayer under section 1.1031(k)- 1(k)(2)(ii) and does not disqualify QI from being a qualified intermediary under section 1.1031(k)-1(g)(4)(iii).

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that in general, 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(b) provides that if an exchange would be within the provisions of section 1031(a) if it were not for the fact that the property received in the exchange consists not only of property permitted by such section to be received without recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1.1031(k)-1(a) of the regulations provides that a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of section 1.1031(k)-1 are satisfied.

The relevant qualified use of the property owned by Taxpayer and subsequently being exchanged in the transaction is the leasing of such property to third parties. Thus, the relinquished property that Taxpayer previously leased to third parties and the replacement property that Taxpayer will be leasing to third parties upon acquisition is considered property held for productive use in a trade or business in Taxpayer's hands.

Section 1.1031(a)-1(a) provides that as used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that Code section, be exchanged for property of a different kind or class. As examples, section 1.1031(a)-1(c) provides that "a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose" are like kind.

Section 1.1031(a)-2(b) further provides that depreciable tangible properties are of like class if they are either within the same General Asset Class, as defined in section 1.1031(a)-2(b)(2), or within the same Product Class, as defined in section 1.1031(a)-2(b)(3). Taxpayer states that the vehicles exchanged are not within these General Asset Class or Product Class safe harbors.

The General Asset Class and Product Class safe harbors in the regulations simplify the determination of whether depreciable tangible personal property is of a like kind, but they are not the exclusive method for making this determination. For depreciable tangible personal property to be considered of like kind, the property can be either like kind or like class. Section 1.1031(a)-2(a) of the regulations provides that "an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class." Thus, two properties can be in different General Asset Classes (and thus not be of a like class) and yet be of like kind.

The like-kind standard has been interpreted more narrowly in the case of exchanges of personal property as compared to exchanges of real property. See California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982). Even within the more restrictive parameters of the like-kind standard as applied to personal property, the differences between an automobile and a passenger van or an SUV do not rise to the level of a difference in nature or character but are merely a difference in grade or quality. However, a truck is different in nature or character than an automobile.

Section 1031(a)(3) states that any property received by the taxpayer shall be treated as property that is not like-kind property if (a) such property is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (b) such property is received after the earlier of (i) the day that 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 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) provides that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

In all cases, Taxpayer acquires the replacement property within the time period mandated by section 1031(a)(3).

Section 1.1031(k)-1(f)(1) provides that a transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. Section 1.1031(k)-1(f)(1) further provides that if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides that except as provided in paragraph (g) of this section (relating to safe harbors), the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. Section 1.1031(k)-1(f)(2) further explains that the taxpayer is in actual receipt of the money at the time the taxpayer actually receives the money or receives the economic benefit of the money. The taxpayer is in constructive receipt of money or property at the time the money or other property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.

Section 1.1031(k)-1(g)(1) provides that there are four safe harbors, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money for purposes of section 1031.

Section 1.1031(k)-1(g)(4) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether taxpayer is in actual or

constructive receipt of money before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

However, section 1.1031(k)-1(g)(4) only applies if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary, as provided in paragraph (g)(6) of this section.

Section 1.1031(k)-1(g)(4) further provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and acquires the relinquished property from the taxpayer, transfers he relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(6) provides that an agreement limits a taxpayer's rights as provided in the paragraph (g)(6) only if the agreement provides that the taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

Section 1.1031(k)-1(k)(1) provides that for purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Section 1.1031(k)-1(k)(2) provides that a person is a disqualified person if the person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph, performance of the following services will not be taken into account –

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

QI is a corporation owned by an independent third party. QI has not previously performed services other than routine financial services for Taxpayer. As such, QI is not a "disqualified person" under the regulations.

Taxpayer has assigned to QI its rights to sell the relinquished property. In all instances, the purchaser receives written notice of the assignment prior to the time that the relinquished property is transferred to the purchaser. Title to the property will be transferred from Taxpayer to the purchaser of the property pursuant to the agreement between Taxpayer and purchaser. Thus, QI will be treated as acquiring and transferring the relinquished property.

In addition, Taxpayer assigned its right to purchase replacement property to QI. In all instances, the seller receives written notice prior to the time that the replacement property is transferred to Taxpayer. Title to the property is transferred to Taxpayer. Thus, QI will be treated as acquiring and transferring the replacement property.

The Exchange Agreement provides that Taxpayer will have no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property as required by the regulations. Proceeds from the sale of relinquished property are deposited into the escrow account. To the extent that funds from the sale of the relinquished property are insufficient to cover the purchase of replacement property, Taxpayer deposits funds to cover the amount of the purchases. Taxpayer is, therefore, not in constructive receipt of money held by QI.

Taxpayer is not in actual or constructive receipt of checks written by purchasers of relinquished property or funds held as security deposits. All agreements governing the flow of funds limit Taxpayer's ability to actually or constructively receive those funds.

CONCLUSION

Accordingly, based on your representations and the above analysis, we rule as follows:

1. Each transfer by Taxpayer of a relinquished vehicle and receipt of an identified replacement vehicle in accordance with the Exchange Agreement will constitute a separate and distinct like-kind exchange transaction that qualifies for deferral of gain recognition for federal income tax purposes pursuant to section 1031.

2. Taxpayer will not be in constructive receipt of any money or other property held by QI pursuant to section 1.1031-1(k)-1(f)(1) unless and until such items are actually payable to or received by Taxpayer, on the condition that the requirements of the Exchange Agreement, representations in this ruling request, and other conditions of the safe-harbor test are in fact met.

3. If a lessee elects to have the security deposit held by Taxpayer applied to the purchase of a vehicle, Taxpayer will not be in constructive receipt of the security deposit funds pursuant to section 1.1031(k)-1(f)(1).

4. The exchange pursuant to the Exchange Agreement of each relinquished vehicle for a properly identified and received replacement vehicle will constitute a nontaxable exchange to the extent no cash or other non-like-kind property as defined ins section 1031(b) is received in the exchange. If cash or other non-like-kind property is received in the exchange, any gain with respect to the relinquished vehicles will be recognized only to the extent of such cash or other property.

5. The role of QI in the purchase of vehicles that are not replacement property, and thus not involved in the like-kind exchange constitutes routine financial or trust services for Taxpayer under section 1.1031(k)- 1(k)(2)(ii) and does not disqualify QI from being a qualified intermediary under section 1.1031(k)-1(g)(4)(iii).

CAVEATS

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under Section 6110 of the Internal Revenue Code.

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

Sincerely,

Robert M. Casey
Senior Technician Reviewer
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200241013

Internal Revenue Service (I.R.S.)
Private Letter Ruling (PLR)
Issue: October 11, 2002
July 1, 2002

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Parent =
Taxpayer =
QI =
Bank =
Titling Trust =
Company =
State =

Dear ***:

This letter responds to your request for a private letter ruling submitted on behalf of Taxpayer, requesting a ruling that the transfers of vehicles described below are deferred exchanges qualifying for nonrecognition of gain or loss under section 1031 of the Internal Revenue Code.

FACTS

Taxpayer is owned by Parent, a multi-state financial holding company. Taxpayer is Parent's sole bank subsidiary. Taxpayer uses the overall accrual method of accounting for maintaining its accounting books and filing its federal income tax return, and uses an annual accounting period that ends on December 31.

Taxpayer is engaged in the business of leasing vehicles to consumers and issuing loans to consumers for the purchase of vehicles. Taxpayer currently maintains a portfolio of leased vehicles. These vehicles are automobiles, passenger vans, light duty trucks, and sport utility vehicles ("SUVs"). Typically the leases range from twenty-four months to sixty-six months in duration. Taxpayer has legal title to each vehicle and depreciates each vehicle pursuant to section 168 of the Internal Revenue Code.

Taxpayer restructured its vehicle leasing operations with the intention that the disposition of a vehicle coming off lease (a relinquished vehicle) by Taxpayer to an unrelated party and the acquisition by Taxpayer of a vehicle recently leased from a dealer (a replacement vehicle) will qualify as a like-kind exchange under section 1031. Relinquished vehicles are typically sold to the dealer, the lessee, or a third party through an auction. Replacement vehicles are usually purchased from a member of Taxpayer's dealer network.

To meet the requirements of section 1031, Taxpayer entered into an agreement with QI, under which QI is to act as the qualified intermediary under section 1.1031(k)-1(g)(4) of the Income Tax Regulations. Accordingly, Taxpayer assigns its rights for the sale of relinquished vehicles and the purchase of replacement vehicles to QI. QI is a limited liability company in which Bank, an independent third party financial institution, is the sole member. Neither Bank nor QI has performed services, other than routine financial services, for Taxpayer.

QI maintains three accounts for Taxpayer: a Sales Proceeds Account, a Transferor Disbursement Account, and a Transferor Underdraft Account. The Sales Proceeds Account holds amounts received by QI from the sale of relinquished vehicles. Such amounts are either received directly via (i) checks or wire transfers from auction houses or dealers, (ii) personal checks, (iii) cashier's checks, or (iv) checks from insurance companies. Payments made by personal or cashier's check are first mailed to Taxpayer for verification that the check is made payable in the proper amount to QI. The verified checks are then forwarded to QI for deposit into the Sales Proceeds Account.

When Taxpayer acquires vehicles, payment to dealers occurs when the dealer draws upon the Transferor Disbursement Account held by QI. The funds in this account result from the transfer of funds from the Sales Proceeds Account. If sufficient funds are not available for transfer from the Sales Proceeds account to fund drafts drawn on the Transferor Disbursement Account, supplemental funds are separately transferred as needed by Taxpayer to the Transferor Disbursement Account.

The Exchange Agreement expressly limits Taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by QI before the end of the exchange period. For this purpose, the exchange period begins on the day of the sale of the relinquished vehicle and ends at midnight on the earlier of the 45th day following the sale of the relinquished vehicle if no replacement vehicle has been identified. If a replacement vehicle is identified before midnight on the 45th day following the sale of the relinquished vehicle, the exchange period will end at the earlier of midnight of the 180th day following the sale, or when Taxpayer actually receives the replacement property.

The Exchange Agreement authorizes QI to purchase all leased vehicles on Taxpayer's behalf, including vehicles that will not be replacement vehicles for purposes of a like-kind exchange. Non-replacement vehicles are purchased by QI and paid for out of the Transferor Disbursement Account in the same procedures applicable to replacement vehicle purchases. This is done because Taxpayer currently acquires more vehicles than are being relinquished and it matches each replacement vehicle with one relinquished vehicle for basis tracking purposes. The unmatched vehicles are non-replacement vehicles.

In order to obtain financing on its purchased vehicles, Taxpayer created Company, which in turn created Titling Trust, a State business trust. Company is the sole beneficiary of Titling Trust. The creation of a State business trust allowed Taxpayer to offer more favorable financing structure to its lenders.

Taxpayer plans to have vehicles sold and purchased by Titling Trust. Therefore, all leased vehicles that Taxpayer owns for federal income tax purposes will be owned through the Titling Trust structure described above. Taxpayer will not make an election to have Company and Titling Trust recognized as separate entities for federal income tax purposes, and therefore, Taxpayer states that Company and Titling Trust will be disregarded for federal income tax purposes. Therefore, Taxpayer states that the Titling Trust's acquisition of title to purchased vehicles will be treated the same as if Taxpayer acquired those vehicles directly.

For matters outside federal income tax purposes, the Titling Trust will be a recognized entity. Dealers will negotiate vehicle leases on behalf of the Titling Trust, and the Titling Trust will hold title to the vehicles. Taxpayer will act as servicer for the Trust, and will collect and process payments, send payment statements, investigate payment delinquencies, prepare tax reports, pay state and local taxes on vehicles, negotiate with lessees on leases nearing maturity, handle amendments or modifications to leases, and dispose of vehicles on matured or defaulted leases. Taxpayer will also maintain certificates of title and other records in its files, prepare an informational schedule for the Titling Trust of all vehicles and leases owned by the Trust, and prepare a monthly report of collections and disbursements.

Sale of Relinquished Vehicles

The actual exchange transactions take place as described in the following paragraphs. Taxpayer's portfolio of leased vehicles includes three automobiles ("Vehicle A", "Vehicle B" and "Vehicle C"). The sale of each of those vehicles commences when, approximately 180 days, and then 35 days, prior to the termination of their leases, the lessees receive a letter (collectively referred to as the "Option Letters") from Taxpayer detailing the lessee's options at the end of the lease term. Such options include extending the lease on the vehicle, relinquishing possession of the vehicle to Taxpayer, or purchasing the vehicle from Taxpayer. The Option Letters notify the lessees to contact Taxpayer's voice response unit ("VRU") to obtain the purchase price of the vehicle if the lessee is interested in purchasing the vehicle.

Vehicle A

The lessee of Vehicle A decides to purchase Vehicle A from Taxpayer using funds borrowed from Taxpayer in a separate and distinct arm's length transaction. Consequently, the lessee contacts Taxpayer's VRU to obtain the purchase price of the vehicle. Next, Taxpayer sends a package of documents ("Purchase Kit") to the lessee, which includes a cover letter, bill of sale, power or attorney, and an odometer disclosure statement ("Payoff Documents"). The Payoff Documents provide the purchase price of the vehicle and specify that the payoff must be made payable to QI and mailed to Taxpayer for verification. The bill of sale also notifies the lessee that Taxpayer's rights to sell Vehicle A are assigned to QI.

At the end of the day on which the lessee obtains the payoff quote, the VRU will automatically fax to QI a list detailing all quotes provided to lessees on that day ("VRU Quote List"). The VRU Quote List includes the name of the lessees and the description of the vehicles. The VRU Quote List also includes notification to QI that Taxpayer's rights to sell the vehicles listed in the statement are assigned to QI.

To complete the sale transaction of Vehicle A, the lessee and Taxpayer execute a debt instrument, in which the Taxpayer issues a cashier's check. Pursuant to the debt agreement, Taxpayer forwards the check to QI for deposit into the Sales Proceeds Account.

Vehicle B

The lessee of Vehicle B decides not to acquire the leased vehicle. Before the lease ends, the dealer who originally arranged the lease purchases the vehicle. The dealer contacts Taxpayer's VRU to obtain a payoff quote. Taxpayer documents the payoff quote in a Payoff Confirmation Letter faxed both to the dealer and to the QI. The Payoff Confirmation Letter will document the purchase price of the vehicle and specify that payoff should be made payable to QI and mailed to Taxpayer for verification. The Payoff Confirmation Letter also provides notice that Taxpayer assigned its right to sell Vehicle B to QI. The dealer sends a check, payable to QI, to Taxpayer who verifies the amount and forwards the check to QI for deposit in the Sales Proceeds Account.

Vehicle C

Neither the lessee nor the dealer who arranged the lease will purchase Vehicle C. Therefore, upon the returning of the vehicle by the lessee to Taxpayer, Vehicle C will be sold at auction. Taxpayer notifies QI of this by faxing it an Auction Sales report, which provides information identifying Vehicle C. In addition, this report includes language notifying QI that Taxpayer's rights to sell Vehicle C have been assigned to QI. When the auction takes place, the auction house, which has authority to execute a transfer of title on behalf of Taxpayer, attaches to the title a statement notifying the purchaser that Taxpayer's rights to sell Vehicle C are assigned to QI. After the sale, the auction house transmits the sales proceeds via wire transfer directly the Sales Proceeds Account.

Acquisition of Replacement Vehicles

To acquire replacement vehicles, Titling Trust purchases the following three vehicles: a passenger van ("Vehicle D"), an SUV ("Vehicle E"), a light-duty truck ("Vehicle F"). In addition to the above three vehicles, a fourth vehicle, an automobile ("Vehicle G") is purchased through QI, using the same methods used to purchase Vehicles D, E, and F. These vehicles are acquired pursuant to contracts Taxpayer has entered into with unrelated dealerships, in which Taxpayer agrees to purchase from the dealer each vehicle leased by the dealer to the lessee under certain terms and conditions. Pursuant to these agreements, Taxpayer will direct the dealers to title the vehicles in the name of the Titling Trust.

All four of the vehicles (Vehicles D, E, F, and G) are acquired under Taxpayer's standard lease program. Under this program, the dealer has the lessee complete a credit application form. Next, the dealer faxes this application to Taxpayer, acting as servicer to Titling Trust, for review and approval. If approved, Taxpayer faxes to the dealer a credit approval form, which includes an assignment of rights to QI. This credit approval form is also sent to QI via electronic file transfer. After the necessary paperwork has been completed by all parties to the transaction, the dealers will obtain payment for Vehicles E, F, D, and G by drawing on the Transferor Disbursement Account using the drafts that were previously distributed to the dealers by Taxpayer.

In the month following the transaction, Taxpayer generates a report that matches the vehicles, indicating that (i) Vehicle D was the replacement vehicle for Vehicle A, (ii) Vehicle E was the replacement vehicle for Vehicle B, (iii) Vehicle F was the replacement vehicle for Vehicle C and (iv) Vehicle G was not a replacement vehicle.

REQUESTED RULING

The transfers of Vehicles A, B, and C, followed by the acquisition of Vehicles D, E, and F are deferred exchanges of Vehicle A for Vehicle D, Vehicle B for Vehicle E, and Vehicle C for Vehicle F, each qualifying for nonrecognition of gain or loss under section 1031.

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that in general, 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 1.1031(k)-1(a) of the regulations provides that a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In order to constitute a deferred exchange, the transaction must be an exchange (i.e. a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of section 1.1031(k)-1 are satisfied.

The relevant qualified use of the property owned by Taxpayer and subsequently being exchanged in the transaction is the leasing of such property to third parties. Thus, the relinquished property that Taxpayer previously leased to third parties and the replacement property that Taxpayer will be leasing to third parties upon acquisition is considered property held for productive use in a trade or business in Taxpayer's hands.

Section 1.1031(a)-1(a) provides that as used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that Code section, be exchanged for property of a different kind or class. As examples, section 1.1031(a)-1(c) provides that "a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose" are like kind.

Section 1.1031(a)-2(b) further provides that depreciable tangible properties are of like class if they are either within the same General Asset Class, as defined in section 1.1031(a)-2(b)(2), or within the same Product Class, as defined in section 1.1031(a)-2(b)(3). Taxpayer states that the vehicles exchanged are not within these General Asset Class or Product Class safe harbors.

The General Asset Class and Product Class safe harbors in the regulations simplify the determination of whether depreciable tangible personal property is of a like kind, but they are not the exclusive method for making this determination. For depreciable tangible personal property to be considered of like kind, the property can be either like kind or like class. Section 1.1031(a)-2(a) of the regulations provides that "an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class." Thus, two properties can be in different General Asset Classes (and thus not be of a like class) and yet be of like kind.

The like-kind standard has been interpreted more narrowly in the case of exchanges of personal property as compared to exchanges of real property. See California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982). Even within the more restrictive parameters of the like-kind standard as applied to personal property, the differences between an automobile (Vehicles A and B) and a passenger van (Vehicle D) or an SUV (Vehicle E) do not rise to the level of a difference in nature or character but are merely a difference in grade or quality. However, a truck (Vehicle F) is different in nature or character than an automobile (Vehicle C).

Section 1031(a)(3) states that any property received by the taxpayer shall be treated as property that is not like-kind property if (a) such property is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (b) such property is received after the earlier of (i) the day that 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 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) provides that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

In all cases, Taxpayer acquires the replacement property within the time period mandated by section 1031(a)(3).

Section 1.1031(k)-1(f)(1) provides that a transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. Section 1.1031(k)-1(f)(1) further provides that if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides that except as provided in paragraph (g) of this section (relating to safe harbors), the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. Section 1.1031(k)-1(f)(2) further explains that the taxpayer is in actual receipt of the money at the time the taxpayer actually receives the money or receives the economic benefit of the money. The taxpayer is in constructive receipt of money or property at the time the money or other property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.

Section 1.1031(k)-1(g)(1) provides that there are four safe harbors, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money for purposes of section 1031.

Section 1.1031(k)-1(g)(4) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether taxpayer is in actual or constructive receipt of money before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

However, section 1.1031(k)-1(g)(4) only applies if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary, as provided in paragraph (g)(6) of this section.

Section 1.1031(k)-1(g)(4) further provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and acquires the relinquished property from the taxpayer, transfers he relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(6) provides that an agreement limits a taxpayer's rights as provided in the paragraph (g)(6) only if the agreement provides that the taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

Section 1.1031(k)-1(k)(1) provides that for purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Section 1.1031(k)-1(k)(2) provides that a person is a disqualified person if the person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph, performance of the following services will not be taken into account –

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.
QI is a limited liability corporation owned by an independent third party financial institution. QI has not previously performed services other than routine financial services for Taxpayer. As such, QI is not a "disqualified person" under the regulations.

Taxpayer has assigned to QI its rights to sell the relinquished property. In all instances, the purchaser receives written notice of the assignment prior to the time that the relinquished property is transferred to the purchaser. Title to the property will be transferred from Titling Trust to the purchaser of the property pursuant to the agreement between Taxpayer and purchaser. Thus, QI will be treated as acquiring and transferring the relinquished property.

In addition, Taxpayer assigned its right to purchase replacement property to QI. In all instances, the seller receives written notice prior to the time that the replacement property is transferred to Taxpayer. Title to the property is transferred to Titling Trust. Thus, QI will be treated as acquiring and transferring the replacement property. Accordingly, QI, acting in accordance with the Exchange Agreement, will be treated as a qualified intermediary and will be treated as acquiring and transferring each relinquished property and each replacement property.

The Exchange Agreement provides that Taxpayer will have no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property as required by the regulations. Proceeds from the sale of relinquished property are deposited into the Sales Proceeds Account. To the extent that funds from the sale of the relinquished property are insufficient to cover the purchase of replacement property, Taxpayer deposits funds to cover the amount of the purchases in the Transferor Disbursement Account.

Taxpayer is not in actual or constructive receipt of checks written by purchasers of relinquished property. All agreements governing the flow of funds limit Taxpayer's ability to actually or constructively receive those funds.

CONCLUSION

Accordingly, based on your representations and the above analysis, we rule that:

The transfers of Vehicles A and B followed by the acquisition of Vehicles D and E are deferred exchanges of Vehicle A for Vehicle D and Vehicle B for Vehicle E, each qualify for nonrecognition of gain or loss under section 1031.

CAVEATS

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under Â§ 6110 of the Internal Revenue Code.

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

Sincerely,

Robert M. Casey
Senior Technician Reviewer
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200241016

Internal Revenue Service (I.R.S.)
Private Letter Ruling (PLR)
Issue: October 11, 2002
July 1, 2002

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Parent =
Subsidiary 1 =
Subsidiary 2 =
Taxpayer =
Dealers =
Equipment A =
Equipment B =
Division 1 =
Division 2 =
QI =
Escrow Holder =
Bank =
Account =
Date A =
x Days =
Agreement A =
Settlement =
Subaccounts A, B, C, and D =
Account X =
Company =

Dear ***:

This letter responds to your request for a private letter ruling submitted on behalf of Parent, requesting certain rulings under section 1031 of the Internal Revenue Code, including a ruling that the transfers of equipment described below are deferred exchanges qualifying for nonrecognition of gain or loss under that provision.

FACTS

Taxpayer is a wholly owned subsidiary of Subsidiary 1. Subsidiary 1 is a wholly owned subsidiary of Subsidiary 2. Subsidiary 2 is a wholly owned subsidiary of Parent, a manufacturer of certain equipment. For federal income tax purposes, Parent, Subsidiary 1, Subsidiary 2 and Taxpayer are included in the consolidated income tax returns of Parent. Taxpayer's overall accounting method is accrual. For maintaining its accounting books and filing its federal income tax return, Taxpayer uses an annual accounting period that ends on October 31. Taxpayer is engaged in the business of leasing equipment to customers of various independent dealers who sell equipment manufactured by Parent, and in limited circumstances, leasing equipment directly to dealers. Of Taxpayer's various leasing divisions, Division 1 and Division 2 are the subjects of the below ruling requests.

QI uses the accrual method of accounting and maintains its accounting records and files its federal income tax returns on a calendar year. Neither the Taxpayer nor Parent has any equity or ownership interest in QI or any affiliate of QI. Prior to the below transactions, there has been no previous financial or other relationship between the QI and Taxpayer or Parent.

Escrow Holder is a subsidiary of Bank and uses the accrual method of accounting. Escrow Holder maintains its accounting books and files its federal income tax returns on a calendar year. You represent that any interest held by Parent in Escrow Holder or Bank represents less than a 10 percent interest in any class of Bank's outstanding securities. Bank has maintained bank accounts, acted as a lock box and acted as an administrative agent in commercial paper issuance for Taxpayer in the past. A Bank subsidiary separate from Escrow Holder has acted as a co-underwriter in the issuance of bonds by Parent, but is not Parent nor Taxpayer's regular investment banker.

In the course of its leasing business, Taxpayer regularly disposes of depreciable tangible property and regularly acquires new property that, you represent, is like-kind. Taxpayer wishes to implement the following program of like-kind exchanges under section 1031, which will result in the deferral of tax associated with gains realized upon disposal of such assets. Taxpayer seeks to reconcile the requirements of section 1031 with its long established business practices. Taxpayer maintains a portfolio of equipment manufactured by Parent or a subsidiary of Parent, which Taxpayer purchases from sellers. All such equipment owned by Taxpayer is leased to third parties and held for productive use in its business. The lease transactions subject to this ruling request are only those leases in which Taxpayer holds legal title to and depreciates the equipment pursuant to section 168. Taxpayer maintains its records for outstanding leases on a specific lease accounting software system ("Lease System").

In a majority of current equipment purchase transactions and many sales transactions, Taxpayer's counterparty is a dealer. These transactions include sales of equipment from Taxpayer's lease portfolio at the end of a lease and purchases of equipment in connection with the initiation of a new lease.

Where a dealer is the buyer or seller of equipment, amounts receivable by Taxpayer on sales or payable on purchases are netted between the dealer, Parent and Taxpayer. You represent that none of the dealers who engage in such transactions with Taxpayer are related persons with respect to Taxpayer within the meaning of section 1031(f)(3). Dealers generally acquire new equipment from Parent or one of Parent's subsidiaries with title passing to the dealer. The equipment purchased by Dealer is initially financed through floor plan financing provided by Parent or a subsidiary other than Taxpayer.

In all of its leasing divisions, Taxpayer acquires the overwhelming majority of equipment purchased at initiation of leases from a dealer. Dealers apply to participate in the leasing program for certain divisions, including Division 1 and Division 2. When a dealer identifies a potential equipment lessee, the dealer will negotiate a price for the equipment; arrange for standard form lease documents to be processed through Taxpayer; and transmit such forms to Taxpayer. Taxpayer inputs the lease application information into its Lease System and reviews the lessee's credit rating. Taxpayer then approves or rejects the lease application. Upon approval, Taxpayer prepares lease documents for both Equipment A leases and Equipment B leases based upon Parent's Master Lease Agreement.

The lease documents and certain documents evidencing transfer of the equipment's ownership from the dealer to the Taxpayer are returned to the dealer for execution by the lessee and the dealer. After the lessee signs the lease and the dealer signs the documents evidencing transfer of ownership, both are returned to Taxpayer for final approval and input into the Lease System. Upon acceptance of a lease by Taxpayer, title to and ownership of the equipment passes to Taxpayer and the lease is activated. The Lease System records a booking date. Corresponding internal accounting entries are created and a credit for the equipment purchase is placed on the Account maintained for that dealer with Parent. Taxpayer will not tender funds on an equipment purchase from a dealer. Lease originations are recorded daily. (Taxpayer follows the same procedure for purchases of equipment subject to lease initiation from parties other than dealers, except that payment for such equipment is generally in the form of cash transfer by check, wire transfer or automated clearing house ("ACH") deposit to the account of the seller.)

Lease terms for Equipment A and Equipment B leases range from three to five years. Included in the lease is a purchase option allowing the lessee to acquire ownership of the equipment from Taxpayer for a purchase price that is either (i) a preset amount stated in the lease; (ii) a payoff amount calculated according to a formula stated in the lease; or (iii) the fair market value of the equipment at lease termination. Upon exercise of the purchase option, payment for the equipment is made to Taxpayer by check, wire transfer or ACH deposit to accounts maintained by Taxpayer in third party depository institutions. If the lessee does not purchase the equipment, Taxpayer grants the dealer who originated the lease the option to buy the equipment. If that dealer does not purchase the equipment, Taxpayer generally will make the equipment available to other dealers and then to third parties for purchase. If the originating dealer or another dealer wants to purchase equipment coming off lease, a member of Parent's group may extend credit to the purchasing dealer. When Parent debits the Account for the purchase amount, the dealer is deemed to own the equipment under terms of certain Master Dealer Agreements with Parent for Equipment A or for Equipment B. Taxpayer is credited with receipt of the sales price.

As stated above, Parent maintains an Account for each dealer into which it records all sales and purchases of Parent's equipment. This account also reflects all other activities of the dealer with any entity affiliated with the Parent such as charges for services, finance costs, and promotion credits. For each sale to a dealer by Parent or a subsidiary of Parent, including Taxpayer's sales at lease termination, Parent debits the Account of such dealer for the price of the equipment plus applicable taxes. The debit reflects (i) the dealer's debt to Parent or the selling subsidiary for the purchase price, and (ii) that the dealer owns the equipment. Offsetting credit entries to the dealer's Account arise from a dealer's sales of equipment to Taxpayer in connection with lease originations or from other credits relating to the dealer's transactions with members of Parent's group. The terms of this Account require that any current balance be settled by the dealer monthly by Date A for all activity occurring during the previous month relating to Parent and its subsidiaries. The settlement for the debits between Parent and its subsidiaries, including Taxpayer, is made concurrent with and through a certain monthly closing process. The terms of Taxpayer's receivables and payables reflected by debits and credits to the Account for the dealer do not exceed x Days.

Documents involving lease plans and terms for both the Equipment A and Equipment B specifically provide, "if the equipment is purchased [by the dealer] and the lease is accepted by [the Taxpayer], then the purchase price plus applicable taxes will be credited to the dealer's account with [Parent] and used to offset currently due indebtedness of the dealer to [Parent]." When a lease is initiated through Taxpayer's purchase of equipment from a dealer, Parent treats Taxpayer as incurring a liability to Parent to purchase the equipment. Taxpayer's offsetting credits are created when it sells off-lease equipment to a dealer. Parent applies net dealer credit balances towards repayment of that dealer's obligations to other members of Parent's group arising from goods or services purchases or other charges. Members of Parent's group other than Taxpayer may also extend credit to dealers when the dealer wants to purchase equipment coming off lease, and will remit payment directly to Taxpayer at the direction of the dealer.

Taxpayer is restructuring its leasing operations with the intention that the disposition to an unrelated party of Equipment A or Equipment B coming off lease and upon which a gain is realized by Taxpayer ("Relinquished Property") and the acquisition by Taxpayer of Equipment A or Equipment B respectively from a dealer at the initiation of a lease ("Replacement Property") will qualify as a like-kind exchange under section 1031. Once it initiates this exchange program, Taxpayer expects that multiple exchanges of both types of equipment will commence every month. You represent that Taxpayer will exchange Equipment A only for Equipment A of the same Standard Industrial Classification Code and Equipment B only for Equipment B of the same Standard Industrial Classification Code.

Disposition of Relinquished Equipment

To meet the requirements of section 1031, Taxpayer entered into a Master Exchange Agreement with QI, under which QI is to act as the qualified intermediary under section 1.1031(k)-1(g)(4) of the Income Tax Regulations. In addition, Taxpayer proposes to engage the services of Escrow Holder as depository for a qualified escrow account as defined in section 1.1031(k)-1(g)(3) to effect the proposed exchanges in order to avoid being deemed in actual or constructive receipt of the proceeds from the sales of Relinquished Property which are to be applied towards the purchase of Replacement Property. Accordingly, Taxpayer is assigning its rights under existing leases to the sale of all leased equipment (Relinquished Property) owned by Taxpayer for certain outstanding leases. Thereafter, and on a periodic basis, Taxpayer will assign to the QI its rights to sell the leased equipment to

lessees. This Master Exchange Agreement provides for the QI's blanket acceptance of all assignments by Taxpayer of its rights under contracts to sell equipment which will constitute Relinquished Property in an exchange.

Lessees will be advised in writing of the assignment of the Taxpayer's sales rights to the QI at the same time the lessee is given a payoff quote and the requirement that equipment purchase payments be remitted to the QI. If a lessee declines to exercise its purchase option and a dealer wants to purchase equipment coming off lease, the purchasing dealer will call Taxpayer for a payoff quote. If the dealer decides to purchase the equipment, the Sales Agreement will inform the dealer that Taxpayer will be assigning its right to sell the equipment to the QI. The consent by the dealer to the assignment of the Taxpayer's right to the QI is also included in this Sales Agreement. A similar procedure will be followed where a nondealer third party other than a lessee is the purchaser of the equipment.

After a Sales Agreement is executed by a purchaser and returned to Taxpayer, Taxpayer will execute the Sales Agreement and concurrently assign its rights to the QI on the form incorporated into the Sales Agreement. Taxpayer will then create a journal voucher containing the payoff information. This journal voucher and Sales Agreement will be received by Taxpayer's accounting department, which will confirm to the QI in writing Taxpayer's assignment of rights to sell the specific equipment and to collect the corresponding consideration. The accounting department will then make specific entries into the Lease System, which will terminate the specific lease. The internal accounting represented by posting the journal vouchers will be batched each business night and will post a debit to the Account for the purchasing dealer. The posting of this debit is treated by Taxpayer and the dealer as creating a receivable and transferring title to the Relinquished Property to the dealer. Legal ownership, however, remains with Taxpayer until the QI completes the sale of the Relinquished Property. For purchases by a lessee or dealer outside the Account process, the sale is deemed complete when the purchase proceeds are received by the QI and deposited into the Escrow Account. Taxpayer will confirm the equipment sale with the QI by transmitting a summary schedule of equipment sales to the QI. As a consequence of its sale of equipment on credit, the QI will hold the receivable from the dealer, which is reflected as a debit on the Account for the dealer. The QI will assign the receivable to another company within the Parent group in exchange for payment to QI of the face amount of the receivable pursuant to Agreement A below.

Taxpayer will also record disposition of the equipment within its proposed like-kind exchange asset software. This sale date commences the Identification Period and the Exchange Period with respect to the property which is determined to be Relinquished Property under the terms of Taxpayer's Exchange Agreement.

Acquisition of Replacement Equipment

You represent that Taxpayer expects that all exchanges will take place within the Identification Period required by section 1031(a)(3) as applicable to each respective Relinquished Property. However, Taxpayer may determine to extend its replacement period timing up to and including the end of the applicable Exchange Period for a specific Relinquished Property, subject to proper identification of Replacement Property pursuant to the requirements in section 1.1031(k)-1(c) of the regulations. Taxpayer's processing of Replacement Property acquisitions will generally follow the procedures applicable to its equipment purchases until a prospective lessee's credit is approved.

The lease documentation to be sent by Taxpayer to a dealer will include a certain Sale form for execution by the dealer, which will provide (i) the terms of the purchase of the equipment by Taxpayer from the dealer, (ii) that Taxpayer will assign its purchase rights to the QI, and (iii) that the dealer consents to the assignment. The Master Exchange Agreement provides for the QI's blanket acceptance of all assignments by Taxpayer of its rights under contracts to purchase equipment which will constitute Replacement Property in an exchange.

The business day after sending new lease documentation to the dealer, a summary of the approved lease will be sent to the QI confirming Taxpayer's assignment of its right to purchase the equipment subject to the new lease agreements. The notification form will include the equipment's cost and a specific description, but advises that the actual purchase is to be deferred pending Taxpayer's receipt and approval of executed documentation. Upon Taxpayer's receipt of lease documentation executed by a lessee and the Sales form executed by the dealer, Taxpayer reviews the documents to verify that they conform to the approved transaction. If the documents are proper, Taxpayer will execute the lease and ownership of the equipment passes to Taxpayer at that time. The new lease is activated in the Lease System.

Each business day, Taxpayer will prepare a summary of the leases entered into the Lease System and executed the previous business day and will forward the summary to QI. The summary verifies purchases of equipment by QI, and therefore QI's obligation to pay consideration to the equipment sellers. Funding to pay for Replacement Property will come from Subaccount D maintained by Escrow Holder, pursuant to joint instructions from Taxpayer and QI. This may be by wire transfer, ACH transfer or check drawn on the account. To the extent that the proceeds from the sale of Relinquished Properties are insufficient to cover the purchase price of corresponding Replacement Properties, Taxpayer will direct QI to use the disposition proceeds that were previously designated as Non-Qualified Proceeds and held in the Escrow Account, or, Taxpayer will transfer additional funds into the Escrow Account.

Exchange Agreement

Taxpayer will enter into the Exchange Agreement with QI pursuant to which the QI agrees to acquire and transfer equipment owned by Taxpayer (i.e., Relinquished Property) to various buyers (lessees, dealers or other third parties) in consideration of, and in exchange for, the acquisition of like-kind equipment (i.e., Replacement Property) from various sellers to QI and the subsequent transfer of such Replacement Property to Taxpayer. Taxpayer will assign to QI all its rights to sell all of its Equipment A and Equipment B and its rights to purchase Replacement Property.

The Exchange Agreement provides that in any disposition of property where Taxpayer extends credit to the buyer, the QI shall, at Taxpayer's direction, assign the resulting receivable to a third party in return for consideration equal to the full face amount of the receivable. It is anticipated that such assignments will be made to members of Parent's group. Payment for assigned receivables is to be made to the QI within several days of the creation of the receivable. Terms for the purchase of QI receivables are reflected in Agreement A which Taxpayer proposes will be implemented between a member of Parent group and QI. Any other sales of receivables would be pursuant to substantially identical terms. Further, the Exchange

Agreement provides that in any equipment acquisition in which the seller extends credit to QI, as Taxpayer's assignee, QI's obligations shall, at Taxpayer's direction, be assigned to and assumed by a third party member of Parent group pursuant to Agreement A immediately after completion of the purchase by QI as Taxpayer's assignee. These assignments convert receivables and payables into funding which allows QI to purchase new equipment and allows the dealer obligations to be ultimately settled through Account X consistent with its longstanding practice.

You represent that the Exchange Agreement is intended to serve as the written agreement governing the QI's role in all exchanges contemplated by Taxpayer, as required by section 1.1031(k)-1(g)(4)(iv) of the regulations. The Exchange Agreement provides that QI may act as a collection and disbursement agent with respect to sales proceeds of leased Equipment A and Equipment B, which do not constitute Relinquished Property in a like-kind exchange. This procedure is adopted due to administrative hardship that would be associated with the internal segregation of the processes for collection of Relinquished Property sales proceeds from the processes for collection of proceeds from sale of equipment coming off lease which will not be transferred in a like-kind exchange.

Escrow Agreement

Taxpayer, QI and Escrow Holder will enter into Escrow Agreement, which establishes terms for creating an Exchange Fund. The Escrow Agreement provides that Taxpayer is or will be the owner of the Relinquished Property [ies] and other properties that Taxpayer intends to have QI sell to third party buyers as Taxpayer's agent pursuant to the Exchange Agreement. Proceeds from sales of Relinquished Property [ies] will be deposited into the Exchange Fund with the Escrow Holder and will be subject to the terms and conditions of the Escrow Agreement.

Escrow Agreement provides that the Escrow Holder will maintain Subaccounts within the Exchange Fund for collection and retention of funds received by QI from sales of Taxpayer's equipment. All proceeds received by QI from parties other than Parent are expected to be deposited into Subaccount A. Once the source of funds in Subaccount A can be identified as the proceeds from sales of Equipment A or sales of Equipment B, these funds will be separated and transferred into either Subaccount B or Subaccount C, which are established to segregate such proceeds respectively for administrative purposes. Relinquished Property proceeds and all investment earnings thereon are to be generally maintained in one of these subaccounts. Proceeds received pursuant to Agreement A will be deposited directly into one of these subaccounts as the type of equipment for which the payment is due will be known at the time of the payment. Subaccount D will also be established for Equipment A and Equipment B. All disbursements to purchase Replacement Properties will be made from Subaccount D. Accordingly, it is possible for funds derived from a sale of a Relinquished Property which constitutes Equipment A to be utilized by the QI to satisfy its obligations to purchase Relinquished Property which constitutes Equipment B (or vice versa). However, all exchange credits must ultimately balance under terms of the Exchange Agreement on a property by property basis. This structure is intended to assure that Relinquished Property sales proceeds and income derived from those proceeds remain at all times subject to the conditions imposed by section 1.1031(k)-1(g)(6) of the regulations.

Escrow Agreement contains a provision that specifies that Taxpayer shall direct Escrow Holder to invest proceeds held in Subaccount B or Subaccount C, and that any interest or income thereon shall belong solely to QI. The investments will not be made in any security of Taxpayer or any affiliates of Taxpayer. If Taxpayer determines that Escrow Holder is a qualified escrow holder under section 1.1031(k)-1(g)(3)(ii)(A) of the regulations, Taxpayer can by written notice to QI and Escrow Holder require that interest and other amounts or benefits earned in lieu of the payment of interest on the fund belong to Taxpayer. In addition, under Escrow Agreement, Taxpayer has the right to transfer funds between any of the Subaccounts within the Escrow Fund. However, funds cannot be disbursed from Subaccount D within the Escrow Fund without the joint authorization of Taxpayer and QI.

Taxpayer does not have the right to receive, pledge, borrow, or otherwise obtain benefit of any of the exchange proceeds or any other benefits earned in lieu of interest, held or otherwise provided by either QI or Escrow Holder before the end of the exchange period, or, if earlier, the end of the identification period without the corresponding Replacement Property having been identified or received by Taxpayer.
Escrow Agreement also contains a provision that provides that Escrow Holder shall furnish Taxpayer and QI with direct access to Subaccount D for the purpose of making disbursements from Subaccount D. Such direct access may be by paper means, including, without limitation, single or two party negotiable checks by telephone or by electronic means, including, without limitation, access via specialized software, telephone modem dial in, Internet, or by telephone. Taxpayer and QI hereby represent and warrant that neither party shall cause the disbursement of any funds from Subaccount D without due authorization from the other party.

Agreement A

Taxpayer proposes that QI and Company enter Agreement A which permits the conversion into liquid funds of receivables and payables created on QI's sales of Relinquished Property [ies] and purchases of Replacement Property [ies] to and from dealers. Under Agreement A, Company will purchase QI's receivables from dealers at par (that is, with no premium or discount) and will assume QI's payables to dealers at par in connection with QI's services as qualified intermediary in this program.

These purchase and assumption transactions will occur periodically. QI will provide supporting information relating to the receivables and payables created in equipment purchase and sale transactions on behalf of Taxpayer. Company is to remit payment to QI for receivables acquired by Company, and QI is to remit payment to Company for payables transferred to Company. In each case, payment is to be made within two business days after notice and supporting documentation is provided by QI. Funds paid by Company will be deposited into either Subaccount B or Subaccount C within the Escrow Fund held by Escrow Holder, depending upon the type of equipment whose sale created the receivable. Funds due to Company will be paid from Subaccount D within the Escrow Fund maintained by Escrow Holder.

Agreement A is intended to allow Parent's group to account for dealer purchases and sales of equipment through the longstanding dealer account system, while allowing Taxpayer and QI to proceed with the like-kind exchange of Taxpayer's equipment independent of such account processing. You represent that no net economic benefit to Parent, Company, or QI will occur due to the payment for receivables and assumption of payables at par.

Restrictions on Taxpayer's Rights to Relinquished Property Sales Proceeds

The Exchange Agreement and the Escrow Agreement expressly limit Taxpayer's rights to amounts held in the Exchange Fund and its Subaccounts. Under the Exchange Agreement, upon receipt of any funds by QI on the transfer of possible Relinquished Property [ies] to a buyer, QI is obligated to immediately transfer such funds to Escrow Holder for deposit into the Exchange Fund Subaccounts. Any funds held by QI pending their transfer to Escrow Holder and funds held in the Subaccounts maintained by Escrow Holder shall be used solely to enable QI to perform its obligations to acquire Relinquished Property [ies]. The Exchange Agreement further provides that Taxpayer will not have any rights to receive, borrow, pledge or otherwise obtain the benefits of monies held in the Escrow Fund with respect to any Relinquished Property until the end of (i) the applicable "Exchange Period" or, if earlier, (ii) the end of the applicable "Identification Period" if no Replacement Property [ies] are identified or received by Taxpayer. In no event shall funds be disbursed by Escrow Holder until Escrow Holder receives a written notice signed jointly by QI and Taxpayer.

Escrow Agreement provides that all funds held by Escrow Holder derived from the sale of Relinquished Property [ies] or any interest or benefits in lieu of interest earned thereon ("Exchange Proceeds") are subject to the limitation that Taxpayer will not have any right to receive, pledge, borrow, or otherwise obtain the benefit of the Exchange Proceeds until the end of (i) the applicable "Exchange Period" or, if earlier, (ii) the applicable "Identification Period" if no Replacement Property [ies] are identified or received by Taxpayer.

Exchange Agreement and Escrow Agreement both define Identification Period for each Relinquished Property as the period beginning on the date Taxpayer transfers that property and ending at midnight of the 45th day thereafter. Exchange Period is defined with respect to each Relinquished Property as beginning on the date Taxpayer transfers that property and ending on midnight on the earlier of the 180th day thereafter or the due date (with extensions) for Taxpayer's federal income tax return for the year in which the transfer of the Relinquished Property occurred.

In addition, all Exchange Proceeds are initially held in Subaccount A or in either Subaccount B or Subaccount C. Amounts held in either Subaccount B or Subaccount C may not be disbursed except to Subaccount D. If identified as Relinquished Property Proceeds, amounts held in Subaccount D are not to be disbursed, except in connection with the acquisition of Replacement Property [ies], prior to the end of the applicable Exchange Period, or, if earlier, the applicable Identification Period if there are no remaining identified properties with respect to a specific Relinquished Property. However, no amounts will be disbursed from Subaccount D unless joint authorization from both the Taxpayer and the QI is received by the Escrow Holder.

REQUESTED RULINGS

1. Each transfer by the Taxpayer of Relinquished Property and the receipt of Relinquished Property in accordance with Exchange Agreement will constitute a transaction that qualifies for deferral of gain recognition for federal income tax purposes as a like-kind exchange pursuant to section 1031 of the Code.

2. Acting in accordance with the Exchange Agreement, the Escrow Agreement, section 1031 of the Code and the regulations thereunder, the QI will be treated as acquiring and transferring both the Relinquished Property and the Relinquished Property with respect to each exchange.

3. Pursuant to section 1.1031(k)-1(f)(1) of the regulations, the Taxpayer will not be in constructive receipt of any money or other property held by QI or Escrow Holder, including amounts derived from sales of receivables to Parent or other affiliates of Taxpayer, unless such items are actually payable to and deposited by the Taxpayer as long as the requirement of the Exchange Agreement, the Escrow Agreement and the Taxpayer's representations herein are met.

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that in general, 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 1.1031(k)-1(a) of the regulations provides that a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In order to constitute a deferred exchange, the transaction must be an exchange (i.e. a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of section 1.1031(k)-1 are satisfied.

Section 1031(a)(3) states that any property received by the taxpayer shall be treated as property that is not like-kind property if (a) such property is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (b) such property is received after the earlier of (i) the day that 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 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) of the regulations provides that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

Section 1.1031(k)-1(f)(1) provides that a transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property Section 1.1031(k)-1(f)(1) further provides that if the taxpayer actually or constructively receives money or

other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides that except as provided in paragraph (g) of this section (relating to safe harbors), the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. Section 1.1031(k)-1(f)(2) further explains that the taxpayer is in actual receipt of the money at the time the taxpayer actually receives the money or receives the economic benefit of the money. The taxpayer is in constructive receipt of money or property at the time the money or other property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.

Section 1.1031(k)-1(g)(1) provides that there are four safe harbors, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money for purposes of section 1031.

Section 1.1031(k)-1(g)(4) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether taxpayer is in actual or constructive receipt of money before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

However, section 1.1031(k)-1(g)(4) only applies if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary, as provided in paragraph (g)(6) of this section.

Section 1.1031(k)-1(g)(4) further provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(6) provides that an agreement limits a taxpayer's rights as provided in the paragraph (g)(6) only if the agreement provides that the taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period established by section 1031(a)(3)(B) except that under (ii) the agreement may provide that the taxpayer may have rights to the money or other property if at the end of the identification period, the taxpayer has not identified replacement property or (iii) the agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to the money or other property upon or after (A) the receipt by the taxpayer of all replacement property to which it is entitled under the exchange agreement or (B) the occurrence after the end of the identification period of a material and substantial contingency that relates to the deferred exchange, is provided for in writing, and is beyond the control of the taxpayer.

Section 1.1031(k)-1(k)(1) provides that for purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Section 1.1031(k)-1(k)(2) provides that a person is a disqualified person if the person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph, performance of the following services will not be taken into account –

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.
Section 1.1031(k)-1(g)(3)(i) provides that in the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account. Under paragraph (ii) of this section, a qualified escrow account is an escrow account wherein the escrow holder is not the taxpayer or a disqualified person, and the escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account.

There are three general requirements for nonrecognition treatment under section 1031: (1) both the property surrendered and the property received must be held either for productive use in a trade or business or for investment; (2) the property surrendered and the property received must be of "like-kind;" and (3) there must be an exchange as distinguished from a sale and a purchase.

Taxpayer's position is that its transactions pursuant to the above program will qualify as separate deferred like-kind exchange transactions because the Relinquished and Replacement Properties will be like-kind, will be held by Taxpayer for productive use in its business, and will be exchanged for other properties. In its submission, Taxpayer represents that the properties will be like-kind because each piece of equipment exchanged will be in the same product class as listed in the Standard Industrial Classification manual (and Taxpayer has provided a list of such equipment and the corresponding SIC codes). Moreover, the relevant qualified use of the property owned by Taxpayer and subsequently being exchanged in the transaction is the leasing of such property to third parties. Thus, the Relinquished Property that Taxpayer previously leased to third parties and the

Replacement Property that Taxpayer will be leasing to third parties upon acquisition are considered property held for productive use in a trade or business in Taxpayer's hands. In addition, the properties will be exchanged, not sold and purchased, because the Taxpayer will use a qualified intermediary to receive and control the proceeds derived from dispositions of Relinquished Property until Replacement Property is identified and acquired.

In the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and repurchase, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. Actual or constructive receipt of money or other property by an agent of the taxpayer is actual or constructive receipt by the taxpayer.

Section 1.1031(k)-1(g) of the regulations sets forth four safe harbors, the use of any of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for section 1031 purposes. In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the taxpayer's agent for section 1031 purposes. In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

In the instant case, Taxpayer will enter agreements with QI and other parties to the transaction and will assign to QI its rights to sell the Relinquished Property [ies] and to purchase Replacement Property [ies]. QI is not an agent of Taxpayer in connection with exchanges of Relinquished Property [ies] and Replacement Property [ies] because their relationship is intended solely to meet the safe harbor provisions of the above regulations. QI is not Taxpayer nor a disqualified person because QI is not Taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker. QI and Taxpayer had no prior relationship, and QI is not related to Taxpayer under section 267(b) or 707(b) of the Code. Although QI will not be acquiring legal title to any properties, pursuant to section 1.1031(k)-1(g)(4)(iv) QI is treated as acquiring a Relinquished Property from Taxpayer and transferring the Relinquished Property to a party other than Taxpayer if QI enters into agreements to acquire and transfer the Relinquished Property to a party other than Taxpayer and pursuant to such agreements the Relinquished Property is transferred to that party.

Pursuant to section 1.1031(k)-1(g)(4)(v), an intermediary is treated as entering into an agreement if the rights of a party to an agreement are assigned to the intermediary and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of the property. In this case, in all instances, Taxpayer will assign to QI the Taxpayer's right to sell each item of Relinquished Property. Moreover, with respect to any sales to lessees, Taxpayer will notify QI of its assignment of rights to sell the property under the terms of the leases. In the case of a dealer (or another purchaser who is not a dealer or lessee) the notice of Taxpayer's assignment of its sale rights will be contained in the sales agreement transmitted by Taxpayer to purchaser and thus such purchasers will receive written notice of the Taxpayer's assignment of sales rights to QI prior to the time that the Relinquished Property is transferred to the purchaser. Specific confirmation of Taxpayer's assignment of sales rights will be transmitted to the QI prior to or concurrent with completing the sales transaction via the notification to QI of the property sales.

Pursuant to section 1.1031(k)-1(g)(4)(iv) and (v), QI is treated as acquiring Replacement Property from a party other than Taxpayer and transferring the Replacement Property to Taxpayer if it enters into agreements with a third party to acquire and transfer the Replacement Property to Taxpayer and pursuant to that agreement the Replacement Property is transferred to Taxpayer. The QI is treated as entering into agreements to acquire and transfer Replacement Property if rights of Taxpayer to purchase the property are assigned to QI and the parties to the transaction are all notified in writing before the transfer. In this case, under the Exchange Agreement, the QI is assigned all Taxpayer's purchase rights relating Replacement Properties. Confirmation of specific Replacement Properties which QI is to acquire by assignment of Taxpayer's rights is accomplished through dispatch of the Notice of Assignment of Purchase Rights transmitted after lease documentation is sent to a dealer and before a purchase is completed. For purchases from dealers or third parties, Taxpayer will notify the seller of its assignment of purchase rights to QI as part of the lease documentation.

Accordingly, we conclude that pursuant to the above regulations, QI, acting in accordance with the Exchange Agreement, will be treated as a qualified intermediary and will be treated as acquiring and transferring each Relinquished Property and each Replacement Property.

Concerning Taxpayer's right to receive cash or cash equivalents from Escrow Holder, we note that as mandated by section 1.1031(k)-1(g)(3)(ii)(B), the Escrow Agreement contains certain restrictions required by section 1.1031(k)-1(g)(6), including the requirement that joint authorization by Taxpayer and QI is necessary in order to release amounts in Subaccount D.

In addition, the Exchange Agreement requires QI to transfer any funds received upon the transfer of any property to the accounts established by Escrow Holder. As required by the regulations, the Exchange Agreement further provides that Taxpayer will have no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property with respect to Relinquished Property or earnings derived therefrom prior to the end of the Exchange Period or, if earlier, the end of the Identification Period if there are no identified Replacement Properties which have not been acquired. Proceeds from the sale of Relinquished Property are deposited into the appropriate Subaccount. Similarly, procedures applicable to the Escrow Fund and Subaccounts pursuant to the Escrow Agreement assure that Taxpayer will not have the right to pledge, borrow, or otherwise obtain the benefits of money or other property derived from the transfer of a Relinquished Property prior to the expiration of the conditions in section 1.1031(k)-1(g)(6).

The Escrow Agreement also contains procedures for disbursements from Subaccount D which comply with the safe harbor limitations in section 1.1031(k)-1(g)(3) and (6). For instance, Escrow Agreement specifically provides that Taxpayer and QI represent and warrant that neither party shall cause the disbursement of any funds from Subaccount D without due authorization from the other party. Thus, once received, amounts can be disbursed from Subaccount D only by the joint authority of QI and Taxpayer. Accordingly, Taxpayer does not have the unfettered discretion to disburse funds from Subaccount D. Moreover, until the end of the Exchange Period or, if earlier, the end of the Identification Period for any

Relinquished Property if there are no identified Replacement Properties which remain to be acquired, QI may not direct Escrow Holder to disburse amounts to Taxpayer. Therefore, we conclude that Taxpayer does not have actual or constructive receipt of the amounts held in Escrow Fund. Taxpayer also is not in actual or constructive receipt of proceeds from the sale or exchange of property when Taxpayer directs the transfer of funds between the Subaccounts within Escrow Fund because this does not result in any benefit to Taxpayer but instead allows an administrative audit trail of the proceeds from Relinquished Equipment A Property and Relinquished Equipment B Property.

Concerning Agreement A, which provides for sale by QI of receivables created when dealer purchase equipment from QI and for assumption by Company of obligations of QI to dealers created when QI purchases equipment from dealers, there is no netting of such sales and purchase transactions in this process. Each dealer receivable and payable will be separately settled between QI and Company by a transfer of funds to or from Escrow Fund. Conversion of the receivables and payables to cash at par through this system does not result in any net economic benefit to Company or Taxpayer. Company must pay full value for payables it assumes, and it receives full value for receivables it acquires. The above restrictions on Taxpayer's rights "to receive, pledge, borrow or other wise obtain the benefits of money or other property" are intended to prevent Taxpayer from directly or indirectly utilizing the Relinquished Property sales proceeds for purposes other than acquiring Replacement Property during periods such proceeds are held in a qualified escrow or by a qualified intermediary. A transaction between a taxpayer and a qualified intermediary which produces no net benefit to the taxpayer is not considered to violate these strictures. This process does not result in the Taxpayer being deemed in actual or constructive receipt of money or other property.

CONCLUSIONS

1. We conclude that each transfer by the Taxpayer of Relinquished Property and the receipt of Relinquished Property in accordance with the Exchange Agreement will constitute a transaction that qualifies for deferral of gain recognition for federal income tax purposes as a like-kind exchange pursuant to section 1031 of the Code.

2. We conclude that as long as QI acts in accordance with the Exchange Agreement, the Escrow Agreement, section 1031 of the Code and the regulations thereunder, it will be treated as acquiring and transferring the Relinquished Property and Relinquished Property with respect to each exchange.

3. We conclude that pursuant to section 1.1031(k)-1(f)(1) of the regulations, the Taxpayer will not be in constructive receipt of any money or other property held by QI or Escrow Holder, including amounts derived from sales of receivables to Parent or other affiliates of Taxpayer, unless such items are actually payable to and deposited by the Taxpayer as long as the requirement of Exchange Agreement, the Escrow Agreement and the Taxpayer's representations are met.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under Section 6110 of the Internal Revenue Code.

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

Sincerely,

Robert M. Casey
Senior Technician Reviewer
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200240049

Internal Revenue Service (I.R.S.)
Private Letter Ruling (PLR)
Issue: October 4, 2002
July 1, 2002

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Parent =
Subsidiary =
Taxpayer =
QI =
Bank =
Administrator =
A =
B =
Lease Program 1 =
Lease Program 2 =

Dear ***:

This letter responds to your request for a private letter ruling submitted on behalf of Taxpayer, requesting a ruling that the transfers of vehicles described below are deferred exchanges qualifying for nonrecognition of gain or loss under section 1031 of the Internal Revenue Code.

FACTS

Taxpayer is a wholly-owned subsidiary of Subsidiary. Subsidiary is owned by Parent, a multi-state bank holding company. Taxpayer uses the overall accrual method of accounting for maintaining its accounting books and filing its federal income tax return, and uses an annual accounting period that ends on December 31.

Taxpayer is primarily engaged in the business of leasing vehicles to consumers and issuing loans to consumers for the purchase of vehicles. Taxpayer currently maintains a portfolio of vehicles leased to customers. These vehicles are automobiles, passenger vans, light duty trucks, and sport utility vehicles ("SUVs"). Typically the leases range from twenty-four months to sixty-six months in duration. Taxpayer has legal title to each vehicle and depreciates each vehicle pursuant to section 168.

Taxpayer restructured its vehicle leasing operations with the intention that the disposition of a vehicle coming off lease (a relinquished vehicle) by Taxpayer to an unrelated party and the acquisition by Taxpayer of a vehicle recently leased from a dealer (a replacement vehicle) will qualify as a like-kind exchange under section 1031. Relinquished vehicles are typically sold to the dealer, the lessee, or a third party through an auction. Replacement vehicles are usually purchased from a member of Taxpayer's dealer network.

To meet the requirements of section 1031, Taxpayer entered into an agreement with QI, under which QI is to act as the qualified intermediary under section 1.1031(k)-1(g)(4) of the Income Tax Regulations. Accordingly, Taxpayer assigns its rights for the sale of relinquished vehicles and the purchase of replacement vehicles to QI.

QI is a limited liability company wholly owned by Bank, which is unrelated to Taxpayer. QI retained Administrator, an unrelated third party, to perform certain administrative duties. Under this arrangement, Administrator records the assignments made to QI on the sale of relinquished vehicles and the purchase of replacement vehicles. Administrator also reviews the requests made for the purchase of replacement vehicles and may authorize payments to be made if the requests are for the purchase of vehicles. Taxpayer does not have any contractual relationship with Administrator. Neither Bank nor QI has performed services, other than routine financial services, for Taxpayer or any party related to Taxpayer.

QI maintains three types of accounts for Taxpayer: two Funding Accounts, two Disbursement Accounts, and an Investment Account. From time to time, QI may establish a Supplemental Account for the depositing of additional funds by Taxpayer in the event there are not enough funds in the other accounts to purchase vehicles.

The Funding Accounts hold amounts received by QI from the sale of relinquished vehicles. Such amounts are either received directly via (i) automated clearing house ("ACH") transfers, (ii) personal checks, or (iii) cashier's checks. Payments made by check are first mailed to Taxpayer for verification that the check is made payable in the proper amount to QI. The verified checks are then forwarded to QI for deposit into one of the Funding Accounts. The funds held in the Funding Accounts are not invested by QI unless Taxpayer instructs QI to transfer amounts from the Funding Accounts to the Investment Account. At the election of Taxpayer, amounts in the Investment Account are invested either in A or B.

All amounts expended by QI in the acquisition of vehicles are funded by disbursements directly from the Disbursement Accounts. The funds in these accounts result from the transfer of funds first from the Funding Accounts, then from the Investment Account and finally from the Supplemental Account.

If the dealer is to be paid via check, Taxpayer writes the check on the appropriate Disbursement Account. Pursuant to the Exchange Agreement, Taxpayer is permitted to write checks on the account solely for the purchase of replacement vehicles and non-replacement vehicles. As confirmation that the checks written during a particular day were for the purchase of replacement vehicles or non-replacement vehicles, Taxpayer must transmit a daily report to QI listing the dealers to be paid by check, the amounts of the checks, and the identification of the related vehicles to be purchased. Upon receipt of this report, QI authorizes payment of the checks and acknowledges its approval by signing the report and faxing a copy back to Taxpayer for its records. If the dealer is to be paid via ACH transfer, Taxpayer instructs QI to execute an ACH transfer to the dealer from the appropriate Disbursement Account.

The Exchange Agreement expressly limits Taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by QI before the end of the exchange period. For this purpose, the exchange period begins on the day of the sale of the relinquished vehicle and ends at midnight on the earlier of the 180th day following the sale of the relinquished vehicle or the due date (determined with extension) for Taxpayer's tax return for the taxable year in which the transfer of relinquished property occurs. The Exchange Agreement provides that Taxpayer has a right to receive money or other property held by QI prior to the end of the exchange period only upon the occurrence of an event described in section 1.1031(k)-1(g)(6)(ii) or (iii).

The Exchange Agreement authorizes QI to purchase all leased vehicles on Taxpayer's behalf, including vehicles that will not be replacement vehicles for purposes of a like-kind exchange. Non-replacement vehicles are purchased by QI and paid for out of the Disbursement Accounts in the same procedures applicable to replacement vehicle purchases. This is done because Taxpayer currently acquires more vehicles than are being relinquished and it matches each replacement vehicle with one relinquished vehicle for basis tracking purposes. The unmatched vehicles are non-replacement vehicles.

Sale of Relinquished Vehicles

The actual exchange transactions take place as described in the following paragraphs. Taxpayer's portfolio of leased vehicles includes three automobiles ("Vehicle A", "Vehicle B" and "Vehicle C"). The sale of each of those vehicles commences when, approximately 180 days prior to the termination of their leases, the lessees receive a letter (the "Option Letter") from Taxpayer detailing the lessee's options at the end of the lease term. Such options include relinquishing possession of the vehicle to Taxpayer, or purchasing the vehicle from Taxpayer. The Option Letter notifies the lessees to contact their Taxpayer representative in order to discuss the end of term options.

Vehicle A

The lessee of Vehicle A decides to purchase Vehicle A from Taxpayer using funds borrowed from Taxpayer. Taxpayer documents the payoff quote in a letter (the "Payoff Letter") mailed to the lessee. The Payoff Letter documents the sales price, provides a payoff voucher to accompany the payment, and specifies that the payoff should be made payable to QI and mailed to Taxpayer for verification. The Payoff Letter also notifies the purchaser that Taxpayer's rights to sell Vehicle A are assigned to QI.

At the end of the day on which the lessee obtains the payoff quote, Taxpayer produces a report documenting all payoff quotes provided during that day, ("Payoff List") including the payoff quote for Vehicle A. Taxpayer notifies QI of all payoff quotes provided that day by faxing the Payoff List to QI at the end of the business day. The Payoff List includes the name of the lessee, the payoff amount, and the description of Vehicle A. The Payoff List also includes notification to QI that Taxpayer's rights to sell the vehicles listed in the statement are assigned to QI.

To complete the sale transaction of Vehicle A, the lessee forwards to Taxpayer a check, made payable to QI, which Taxpayer, after verifying the amount, forwards to QI, for deposit into the appropriate Funding Account. Upon indication from QI that the lessee's check clears, Taxpayer arranges for transfer of title to the lessee.

Vehicle B

The lessee of Vehicle B decides not to acquire the leased vehicle. Before the lease ends, the dealer who originally arranged the lease purchases the vehicle. The dealer contacts Taxpayer to obtain a payoff quote. Taxpayer documents the payoff quote in a Payoff Letter faxed to the dealer, and, in addition, Vehicle B is included on the Payoff List provided to QI. The notifications described above with respect to Vehicle A are similarly provided to the dealer and QI with respect to Vehicle B. The dealer sends a check, payable to QI. Taxpayer verifies the amount and forwards the check to QI for deposit in the appropriate Funding Account. Upon indication from QI that the dealer's check has cleared, Taxpayer arranges for transfer of title to the dealer.

Vehicle C

The lessee of Vehicle C decides not to acquire the vehicle, and the dealer does not want to purchase it. The lessee returns the vehicle to Taxpayer. Taxpayer determines that Vehicle C will be sold through an auction, and notifies QI of this by faxing it a pending sales report, which lists Vehicle C and its expected sales price. In addition, this report includes language notifying QI that Taxpayer's rights to sell the vehicle have been assigned to QI. When the auction takes place, the auction house, which has authority to execute a transfer of title on behalf of Taxpayer, attaches to the title a statement notifying the purchaser that Taxpayer's rights to sell Vehicle C are assigned to QI. After the sale, the auction house transmits the sales proceeds via ACH directly to QI for deposit in the appropriate Funding Account.

Acquisition of Replacement Vehicles

To acquire replacement vehicles, Taxpayer purchases the following three vehicles: a passenger van ("Vehicle D"), an SUV ("Vehicle E"), a light duty truck ("Vehicle F"). In addition to the above three vehicles, a fourth vehicle, an automobile ("Vehicle G") is purchased through QI, using the same

methods used to purchase Vehicles D, E, and F. These vehicles are acquired pursuant to contracts Taxpayer has entered into with unrelated dealerships, in which Taxpayer agrees to purchase from the dealer each vehicle leased by the dealer to the lessee under certain terms and conditions.

Vehicles D and E are acquired under Taxpayer's Lease Program 1, while Vehicles F and G are acquired under Taxpayer's Lease Program 2. Under the Lease Program 1, the dealer has the lessee complete a credit application form. Next, the dealer faxes this application to Taxpayer, for review and approval. If approved, Taxpayer faxes to the dealer a credit approval form, which includes an assignment of rights to QI.

Under the Lease Program 2, the selling dealer in each case has the prospective lessee complete the credit application form, and obtains a credit report on the prospective lessee from an external credit bureau. If the lessee's credit is approved, the lessee is eligible for the Lease Program 2. In such a case, the selling dealer completes a form that includes an assignment of rights to QI. Within 2-3 days of executing the lease contract with the lessee, the dealer delivers the relevant documents to Taxpayer for processing. Upon receipt of the documents, Taxpayer confirms approval of the lease and faxes to QI and the dealer a copy of the credit approval form. This document includes language to confirm notification to QI and the dealer that Taxpayer's right to purchase the vehicle was assigned to QI.

After the necessary paperwork has been completed by all parties to the transaction, payment for replacement vehicles can occur in one of two ways. Taxpayer orders QI to transfer funds via ACH from a Disbursement Account to the bank account of the selling dealer. Or, Taxpayer writes a check to the selling dealer, drawn on the appropriate Disbursement Account. If a check is written, Taxpayer must notify QI of the check so that QI can authorize payment of the check pursuant to the Exchange Agreement. This notification usually occurs at the end of the day, when Taxpayer transmits a list of all checks written on each Disbursement Account during that day.

In the month following the transaction, Taxpayer generates a report that matches the vehicles, indicating that (i) Vehicle D was the replacement vehicle for Vehicle A, (ii) Vehicle E was the replacement vehicle for Vehicle B, (iii) Vehicle F was the replacement vehicle for Vehicle C and (iv) Vehicle G was not a replacement vehicle.

REQUESTED RULING

The transfers of Vehicles A, B, and C, followed by the acquisition of Vehicles D, E, and F are deferred exchanges of Vehicle A for Vehicle D, Vehicle B for Vehicle E, and Vehicle C for Vehicle F, each qualifying for nonrecognition of gain or loss under section 1031.

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that in general, 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 1.1031(k)-1(a) of the regulations provides that a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In order to constitute a deferred exchange, the transaction must be an exchange (i.e. a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of section 1.1031(k)-1 are satisfied.

The relevant qualified use of the property owned by Taxpayer and subsequently being exchanged in the transaction is the leasing of such property to third parties. Thus, the relinquished property that Taxpayer previously leased to third parties and the replacement property that Taxpayer will be leasing to third parties upon acquisition is considered property held for productive use in a trade or business in Taxpayer's hands.

Section 1.1031(a)-1(a) provides that as used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that Code section, be exchanged for property of a different kind or class. As examples, section 1.1031(a)-1(c) provides that "a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose" are like kind.

Section 1.1031(a)-2(b) further provides as a safe harbor that depreciable tangible properties are of like class if they are either within the same General Asset Class, as defined in section 1.1031(a)-2(b)(2), or within the same Product Class, as defined in section 1.1031(a)-2(b)(3). Taxpayer states that the vehicles exchanged are not within these General Asset Class or Product Class safe harbors.

The General Asset Class and Product Class safe harbors in the regulations simplify the determination of whether depreciable tangible personal property is of a like kind, but they are not the exclusive method for making this determination. For depreciable tangible personal property to be considered of like kind, the property can be either like kind or like class. Section 1.1031(a)-2(a) of the regulations provides that "an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class." Thus, two properties can be in different General Asset Classes (and thus not be of a like class) and yet be of like kind.

The like-kind property standard has been interpreted more narrowly in the case of exchanges of personal property as compared to exchanges of real property. See California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982). Even within the more restrictive parameters of the like-kind standard as applied to personal property, the differences between an automobile (Vehicles A and B) and a passenger van (Vehicle D) or

an SUV (Vehicle E) do not rise to the level of a difference in nature or character but are merely a difference in grade or quality and, thus, are like kind property. However, a truck (Vehicle F) is different in nature or character than an automobile (Vehicle C) and, thus, are not like kind property.

Section 1031(a)(3) states that any property received by the taxpayer shall be treated as property that is not like-kind property if (a) such property is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (b) such property is received after the earlier of (i) the day that 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 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) provides that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

In all cases, Taxpayer acquires the replacement property within the time period mandated by section 1031(a)(3).

Section 1.1031(k)-1(f)(1) provides that a transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. Section 1.1031(k)-1(f)(1) further provides that if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides that except as provided in paragraph (g) of this section (relating to safe harbors), the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. Section 1.1031(k)-1(f)(2) further explains that the taxpayer is in actual receipt of the money at the time the taxpayer actually receives the money or receives the economic benefit of the money. The taxpayer is in constructive receipt of money or property at the time the money or other property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.

Section 1.1031(k)-1(g)(1) provides that there are four safe harbors, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money for purposes of section 1031.

Section 1.1031(k)-1(g)(4) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether taxpayer is in actual or constructive receipt of money before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

However, section 1.1031(k)-1(g)(4) only applies if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary, as provided in paragraph (g)(6) of this section.

Section 1.1031(k)-1(g)(4) further provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and acquires the relinquished property from the taxpayer, transfers he relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(5) of the regulations provides that the determination of whether the taxpayer is in actual or constructive receipt of money or other property is made without regard to whether or not the taxpayer is entitled to receive any interest or growth factor with respect to the exchange, provided that the taxpayer's rights to receive such interest or growth factor are limited.

Section 1.1031(k)-1(g)(6) provides that an agreement limits a taxpayer's rights as provided in the paragraph (g)(6) only if the agreement provides that the taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

Section 1.1031(k)-1(k)(1) provides that for purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Section 1.1031(k)-1(k)(2) provides that a person is a disqualified person if the person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph, performance of the following services will not be taken into account –

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

QI is a limited liability company owned by Bank, an unrelated third party. QI and Bank have not previously performed services other than routine financial services for Taxpayer. As such, QI is not a "disqualified person" under the regulations.

Taxpayer has assigned to QI its rights to sell the relinquished property. In all instances, the purchaser receives written notice of the assignment prior to the time that the relinquished property is transferred to the purchaser. Title to the property will be transferred from Taxpayer to the purchaser of the property pursuant to the agreement between Taxpayer and purchaser. Thus, QI will be treated as acquiring and transferring the relinquished property.

In addition, Taxpayer assigned its right to purchase replacement property to QI. In all instances, the seller receives written notice prior to the time that the replacement property is transferred to Taxpayer. Title to the property is transferred to Taxpayer. Thus, QI will be treated as acquiring and transferring the replacement property. Accordingly, QI, acting in accordance with the Exchange Agreement, will be treated as a qualified intermediary and will be treated as acquiring and transferring each relinquished property and each replacement property.

The Exchange Agreement provides that Taxpayer will have no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property as required by the regulations. Proceeds from the sale of relinquished property are deposited into the appropriate Funding Account. To the extent that funds from the sale of the relinquished property are insufficient to cover the purchase of replacement property, QI establishes the Supplemental Account in which Taxpayer deposits funds to cover the amount of the purchases.

Taxpayer is not in actual or constructive receipt of checks written by purchasers of relinquished property. All agreements governing the flow of funds limit Taxpayer's ability to actually or constructively receive those funds.

Taxpayer is not in actual or constructive receipt of proceeds from the sale or exchange of property when Taxpayer directs the investment of funds in the investment account. The determination of whether the taxpayer is in actual or constructive receipt of money or other property is made without regard to whether or not the taxpayer is entitled to receive any interest or growth factor with respect to the exchange because Taxpayer's rights to receive such interest or growth factor are limited.

Taxpayer is not in actual or constructive receipt of proceeds from the sale or exchange of property when Taxpayer writes checks for the purchase of replacement property. The Exchange Agreement provides that payment on all checks written on the Disbursement Accounts must be approved by QI.

CONCLUSION

Accordingly, based on your representations and the above analysis, we rule that: The transfers of Vehicles A and B followed by the acquisition of Vehicles D and E are deferred exchanges of Vehicle A for Vehicle D and Vehicle B for Vehicle E, each qualifying for nonrecognition of gain or loss under section 1031.

CAVEATS

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under Section 6110 of the Internal Revenue Code.

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

Sincerely,

Robert M. Casey
Senior Technician Reviewer
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200236026

Internal Revenue Service (I.R.S.)
Private Letter Ruling (PLR)
Issue: September 6, 2002
June 3, 2002

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

A =
B =
C =
m =
x =
QI =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Dear ***:

This letter responds to your request for a private letter ruling, dated February 26, 2001, submitted on behalf of A, concerning Section 1031 of the Internal Revenue Code. Additional information was submitted in letters dated August 28, 2001, and May 29, 2002.

FACTS

A, a wholly owned subsidiary of B, is engaged in the business of m. A, a calendar year taxpayer, files a consolidated income tax return as part of an affiliated group of corporations. All of the corporations in the affiliated group use the accrual method of accounting.

A's business requires it to periodically dispose of certain properties and/or equipment, some of which is co-owned by other parties, and reinvest in like-kind property. A seeks to characterize the transactions as non-taxable exchanges under Section 1031.

QI has developed a World Wide Web site that facilitates online like-kind exchanges by using the Internet and electronic or wire funds transfers to accomplish these exchanges. QI is an independent third party whose only relationship with A is in connection with the performance of services for A's transactions intended to qualify under Section 1031.

Each authorized user with the right to access QI's secured site has a unique user name and password to access the system. For agreements signed on-line by a particular user, the user confirms that he or she wants to sign the agreement before the document is processed by the on-line system. For any documents that a representative of the QI is required to sign, an electronic agent is utilized to sign that document with the appropriate signature. The system then stores a complete copy of the document with the name of each signer and the time and date that each person signed it. The document is provided a digital thumbprint that generates a unique code for each signature associated with a document. The document cannot be altered without modifying the digital thumbprint. A represents that online methods of executing agreements, transmitting notices of assignments, and making replacement property identifications satisfy the requirements of the Electronic Signatures in Global and National Commerce Act, Pub. L. No. 106-229, 114 Stat. 464 (2000) (the Act).

A and QI entered into an agreement on Date 1 pursuant to which QI agreed to serve as the qualified intermediary for certain transactions, including those addressed in this letter ruling. A, by executing an agreement with QI, may use QI's website to access its process for engaging in deferred multiple-batch, like-kind exchanges. Upon execution of the agreement, QI opened a segregated account for its transactions with A. Each multiple-batch transaction has its own unique subaccount within QI's records. The agreement (1) restricts the use of the proceeds from the sale of relinquished property to the purchase of like-kind replacement property, (2) restricts the payment to A of the sale proceeds and any interest credited to A on those proceeds, and (3) assigns to QI A's rights to sell relinquished property under sale agreements and rights to purchase replacement property under purchase agreements.

The agreement prescribes a "sale period" for each batch account of A, during which one or more items of relinquished property may be transferred by A, with the proceeds from the sale of that relinquished property being received by QI's bank and credited to A's applicable batch account. After the sale period expires, the proceeds in that batch account are reinvested by QI in like-kind replacement property in accordance with A's instructions. A purchases production equipment and materials from numerous vendors. Only equipment and materials that fall within C are included in the like-kind exchange process. A completes an online questionnaire to enable QI to send the wiring instructions and notice of assignment of rights to each purchaser.

QI's bank will receive and deposit the proceeds from the sale of the relinquished property into QI's bank account. A, through QI's website, will then direct QI to reinvest the restricted proceeds from the sale of the relinquished property in like-kind replacement property.

Exchange 1

On Date 2, A agreed to sell to purchaser 1 equipment used in A's trade or business on a property x% owned by A. Purchaser 1 was notified of A's assignment of rights to QI under A's agreement with QI. The agreement provided that title to the property passed from A to purchaser 1 on Date 3, the date purchaser 1 paid for the property in full. After A and purchaser 1 agreed to the terms and conditions of the sale, A completed the online questionnaire on QI's website to inform QI of the sale. Upon receiving notification, QI directed purchaser 1 to send the proceeds directly to QI. Only the funds that QI deposited into the net proceeds account were available to be reinvested in like-kind property. In accordance with the agreement executed by A and QI, A has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held in the net proceeds account maintained by QI.

A located and agreed to acquire like-kind replacement property. Prior to acquisition of the replacement property, the seller of the replacement property was notified of A's assignment of rights to QI to purchase replacement property. A acquired the replacement property before the expiration of both the identification period and the exchange period set forth in Section 1031(a)(3) and Section 1.1031(k)-1(b).

Exchange 2

On Date 4, A agreed to sell and purchaser 2 agreed to buy equipment used in A's trade or business on a property that A owned in its entirety. Purchaser 2 was notified of A's assignment of rights to QI under A's agreement with QI. QI instructed purchaser 2 to send the sale proceeds directly to QI. On Date 5, purchaser 2 tendered full payment of the sale proceeds to QI. Only the funds that QI deposited into the net proceeds account were available to be reinvested in like-kind property. In accordance with the agreement executed by A and QI, A has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held in the net proceeds account maintained by QI.

A located and agreed to acquire like-kind replacement property. Prior to acquisition of the replacement property, the seller of the replacement property was notified of A's assignment of rights to QI to purchase replacement property. A acquired the replacement property before the expiration of both the identification period and the exchange period set forth in Section 1031(a)(3) and Section 1.1031(k)-1(b).

For both Exchange 1 and Exchange 2 it is represented that both the buyer of the relinquished property and the seller of the replacement property were notified of the assignment of A's rights regarding the transaction. The buyers were notified through e-mails that contained wiring instructions and the notification of assignment of rights. The purchaser was notified via a blanket notification, which the purchaser signed and returned to A. Further, A is able to provide a specific description of the property being divested as well as the replacement property being acquired. It is represented that the equipment involved in the exchanges is identified by model number and serial number.

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides 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(a)(2) adds that this subsection does not apply to any exchange of stock in trade or other property held primarily for sale.

There are three general requirements for nonrecognition treatment under Section 1031: (1) both the property surrendered and the property received must be held either for productive use in a trade or business or for investment; (2) the property surrendered and the property received must be of "like-kind;" and (3) there must be an exchange as distinguished from a sale and a purchase.

HELD FOR REQUIREMENT

The property owned by A and exchanged in the above-described transactions is equipment used by A in the business of m. Similarly, the property received by A will be used in that same business. Thus, the relinquished equipment that A disposes of and the replacement equipment that A acquires is considered property held for productive use in A's trade or business.

LIKE-KIND REQUIREMENT

The requirement that the exchanged properties be of like kind refers to the nature or character of the property and not to its grade or quality. Section 1.1031(a)-1(b). To qualify for like-kind exchange treatment, one kind or class of property may not be exchanged for property of a different kind or class. Under Section 1.1031(a)-2(b), depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. It is represented that all of the personal property involved in the subject exchanges falls within the same product class.

When an exchange transaction is deferred, rather than simultaneous, even if the taxpayer trades property for like-kind property, the exchanged properties will not be of like kind if the replacement property is not timely identified and timely received. Section 1031(a)(3) and Â§ 1.1031(k)-1(b) state that any property received by the taxpayer shall be treated as property that is not like-kind property if (a) such property is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (b) such property is received after the earlier of (i) the day that 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. In the present case, the requirements of Section 1031(a)(3) and Â§ 1.1031(k)-1(b) are satisfied because the acquisitions of replacement property occurred prior to the expiration of both the identification period and the exchange period.

EXCHANGE REQUIREMENT

For purposes of Section 1031 and 1.1031(k)-1, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property"). In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). Section 1.1031(k)-1(a). In the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of Section 1031(a) before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or property that does not meet the requirements of Section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. According to Section 1.1031(k)-1(f)(2), actual or constructive receipt of money or other property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

Section 1.1031(k)-1(g) of the regulations sets forth four safe harbors, the use of any of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for Section 1031 purposes. Section 1.1031(k)-1(g)(4)(i) of the regulations provides that, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the taxpayer's agent for Section 1031 purposes. In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Section 1.1031(k)-1(g)(4)(ii) provides that Section 1.1031(k)-1(g)(4)(i) applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

A qualified intermediary, as defined in Section 1.1031(k)-1(g)(4)(iii)(A), must be a person who is not the taxpayer or a disqualified person. According to Section 1.1031(k)-1(k)(2) of the regulations, the term "disqualified person" includes a person who is the taxpayer's agent at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties is treated as the taxpayer's agent at the time of the transaction . However, performance of certain services does not cause an entity to be a "disqualified person." These services include (a) services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under Section 1031, and (b) routine financial title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

A qualified intermediary is a person who enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. Section 1.1031(k)-1(g)(4)(iii)(B). Regardless of whether an intermediary acquires and transfers property under general tax principles, an intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person, and pursuant to that agreement, the relinquished property is transferred to that person. Section 1.1031(k)- 1(g)(4)(iv)(B). An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer. Section 1.1031(k)-1(g)(4)(iv)(C). For these purposes, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. Section 1.1031(k)-1(g)(4)(v).

In the present case, purchaser 1 and purchaser 2 tendered full payment of the proceeds of the sale of the relinquished property to QI. Further, in accordance with the agreement executed by A and QI, A has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held in the account, maintained by QI, in which the money was credited as required by Sectino 1.1031(k)-1(g)(4)(ii) and (6)(i) of the regulations. Thus, A is not in actual or constructive receipt of proceeds of relinquished property.

QI is an independent third party that has not previously performed services for A. As such, QI will not be a "disqualified person" under Â§ 1.1031(k)-1(k). Further, A assigned to QI its rights to sell relinquished property. In the case of both Exchange 1 and Exchange 2, the purchaser received notice of the assignment before the time that the relinquished property was transferred to the purchaser. Thus, QI will be treated as acquiring and transferring the relinquished property pursuant to Section 1.1031(k)-1(g)(4)(iv)(B) and (v).

Lastly, A assigned its right to purchase replacement property to QI. The sellers in the transactions described above received notice of the assignment before the time that the replacement property is transferred to A. Thus, QI will be treated as acquiring and transferring the replacement property pursuant to Section 1.1031(k)-1(g)(4)(iv)(C) and (v). Accordingly, QI, acting in accordance with the agreement, will be treated as a qualified intermediary as defined in Â§ 1.1031(k)-1(g)(4)(iii) of the regulations and will be treated as acquiring and transferring the relinquished property and the replacement property for purposes of Section 1031.

BASIS OF REPLACEMENT PROPERTY

Section 1031(d) provides that if property was acquired in an exchange described in Section 1031, then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by Section 1031 to be received without the recognition of gain or loss, and in part of other property, the basis shall be allocated between the properties (other than

money) received, and for the purpose of the allocation, there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

Based on the facts and representations you provided, and the above analysis, we rule as follows:

For purposes of determining whether Exchange 1 and Exchange 2 qualify for nonrecognition of gain or loss under Sectin 1031 –

(1) A's transfer of each batch of relinquished properties, and the corresponding receipt of related replacement properties, will be treated as a separate and distinct like-kind exchange for purposes of the nonrecognition provisions of Section 1031.

(2) QI, acting in accordance with the agreement between QI and A, will be treated as a qualified intermediary as defined in Section 1.1031(k)-1(g)(4)(iii) of the regulations for purposes of the relinquished property and replacement property under Section 1031.

(3) Pursuant to Section 1.1031(k)-1(f) and (g) of the regulations, A will not be in constructive receipt of any of the proceeds from the sale of relinquished property or any money or other property held by QI unless and until such amounts or items are actually received by A (i.e., if replacement property is not acquired during the exchange period and the related sale proceeds are transferred to A).

(4) Any interest received by A will comply with the safe harbor requirement of Section 1.1031(k)-1(g)(5) and (h) and, therefore, will not result in A's being in actual or constructive receipt of money or other property before A actually receives like-kind replacement property. However, the interest is includible in income under Section 61 and cannot be deferred under Section 1031, even if it is reinvested in like-kind replacement property.

(5) The basis of the replacement property received by A will be the aggregate adjusted bases of the relinquished properties in the exchange, decreased by any money received by A in the exchange and increased by the amount of any gain or decreased by any loss recognized by A in the exchange, allocated among the replacement properties received in proportion to their relative fair market values.

Sincerely,

Stephen Toomey
Assistant to the Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

TECHNICAL ADVICE MEMORANDUM 200224004

Date of Conference: November 29, 2001

LEGEND:

Taxpayer
X
Y
Z
Date 1
Date 2
A
B
C
D
City P
City Q
City R
City S
$h
$i
$j
$k
$l

ISSUE:

Is the assigned frequency of the electromagnetic spectrum referred to in a Federal Communications Commission (FCC) television broadcast station license (television license) acquired by Taxpayer on Date 2 the sole underlying property to which the television license relates for purposes of the nonrecognition rules under § 1031 of the Internal Revenue Code?

CONCLUSION:

The assigned frequency of the electromagnetic spectrum referred to in the television license is the sole underlying property to which the television license relates.

FACTS:

Taxpayer is the parent company of an affiliated group that files a consolidated return on a 52-53 week taxable year. X, a subsidiary that was a member of Taxpayer's consolidated group, entered into an asset exchange agreement on Date 1, with Y. Y was subsequently acquired by a consolidated group with Z as the parent company. Pursuant to the agreement, on Date 2, X transferred to Y radio station A in City P, radio station B in City Q, and radio station C in City R, and acquired from Y television station D in City S.

Taxpayer reported for financial reporting purposes that the television station acquired in the exchange had a fair market value of $h, while the radio stations surrendered in the exchange had a basis of $i. Taxpayer, therefore, reported a pre-tax, non-cash, non-operating gain of $j for financial reporting purposes. The FCC licenses represented the largest portion of the exchange with the FCC radio licenses valued at $k and the FCC television license valued at $l.1 For federal income tax purposes, Taxpayer treated the exchange of FCC radio licenses for the FCC television license as an exchange of like kind property under § 1031(a).

As part of the asset exchange agreement, X transferred tangible property to Y and received tangible property from Y. The bulk of such property was radio and television broadcasting equipment that was in the same product class as set forth in the 1987 Standard Industrial Classification ("SIC") Manual. That product class is SIC code number 3663, which is entitled "Radio and Television Broadcasting and Communications Equipment." Certain other equipment transferred by X and Y pursuant to the asset exchange agreement, including towers used to hold radio and television broadcast equipment, was in the same product class as set forth in the SIC Manual. For federal income tax purposes, Taxpayer treated the exchange of this tangible property as qualifying under §1031(a).2

The Communication Act of 1934 (the "Communication Act") grants the FCC the power to license "radio stations." 47 U.S.C. § 303(a) (1995 & 1999 Supp.). Under this grant of authority, the FCC licenses both radio and television broadcasting. FCC regulations define "radio station" as "[a] separate transmitter or group of transmitters under simultaneous common control, including the necessary equipment required for carrying on a radio communications service." 47 C.F.R. § 1.907. FCC regulations define "radio communication" to mean "[t]elecommunication by means of radio waves," which applies to both radio and television broadcasting. 47 C.F.R. § 2.1. Thus, both radio and television are transmitted over the electromagnetic spectrum by radio transmitting equipment.

The Communications Act further grants the FCC the power to "assign frequencies for each individual station and determine the power which each station shall use and the time during which it may operate." 47 U.S.C. § 303(c) (1995 & 1999 Supp.).

The usable radio frequencies of the electromagnetic spectrum range from about 30,000 hertz to 30 gigahertz. Radio broadcasts can be transmitted over frequencies as low as 30 - 3,000 kilohertz (low frequency) to 300 - 3,000 megahertz (ultra high frequency, "UHF"). Television broadcasts can be transmitted over frequencies as low as 30 - 3,000 megahertz (very high frequency, "VHF") to 300 - 3,000 megahertz (UHF). There are 12 VHF channels and 56 UHF channels.

The bandwidth of a radio frequency dictates the amount of information that the frequency can carry. Due to the complexity of a television signal, a much larger bandwidth is needed in comparison to an audio only signal. In the United States, a television channel occupies a width of six megacycles in the radio spectrum. This is 600 times as wide as the channel used by each standard sound broadcasting station.

The rights conferred upon holders of FCC licenses (both radio and television) are described in the FCC licenses themselves. Each of the licenses involved in the exchange expressly states that "the licensee is hereby authorized to use and operate the radio transmitting apparatus herein described." More specifically, each of the FCC licenses confers a right to use the radio transmitting apparatus to broadcast on a designated channel and frequency range, at designated hours of operation, at designated geographic locations, at a maximum effective radiated power, and using antenna with certain antenna system specifications. Section 301 of the Communication Act confirms that the licenses themselves confer the rights held by licensees.

Section 301 provides:

It is the purpose of this chapter, among other things, to maintain control of the United States over all the channels of radio transmission, and to provide for the use of such channels, but not the ownership thereof, by persons for limited periods of time, under licenses granted by Federal authority, and no such licenses shall be construed to create any right, *beyond the terms, conditions, and periods of the license*. 47 U.S.C. § 301 (1995 & 1999 Supp.) (emphasis added).

The FCC licenses (both radio and television licenses) involved reflect the mandate of § 301 in the following language:

This license shall not vest in the licensee any right to operate the station nor any right in the use of the frequency designated in the license beyond the term hereof, nor in any other manner than authorized herein.

Thus, the FCC licenses themselves contain the rights to use radio transmitting apparatus to broadcast programming (whether radio or television) over a portion of the electromagnetic spectrum at a certain power in a designated geographic area.

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 that is to be held either for productive use in a trade or business or for investment. See also § 1.1031(a)-1(a) of the Income Tax Regulations.

Section 1.1031(a)-1(b) provides that "like kind" refers to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under § 1031, be exchanged for property of a different kind or class. See also § 1.1031(a)-2(a).

Section 1.1031(a)-2(c)(1) provides generally that an exchange of intangible personal property or non-depreciable personal property qualifies for nonrecognition of gain or loss under § 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (*e.g.*, a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates. For example, an exchange of a copyright on a novel for a copyright on a different novel is a like kind exchange, but an exchange of a copyright on a novel for a copyright on a song is not a like-kind exchange. Section 1.1031(a)-2(c)(3).

Taxpayer argues that the assigned frequency of the electromagnetic spectrum referred to in the television license is not the only underlying property to which the television license relates.3 Taxpayer asserts that the ability to affiliate with a major television network should also be included as part of the underlying property to which the license relates. Taxpayer contends that the ability to affiliate with a major television network is not attributable to its existence as a separate and identifiable asset but derives from the fact that it inheres in the television license itself.

We reject Taxpayer's argument that the ability to affiliate with a major television network should also be included as part of the underlying property to which the television license relates. The appropriate manner of identifying the underlying property to which the license relates is to look to the license itself. Although the license specifically authorizes Taxpayer to "use and operate the radio transmitting apparatus herein described," the license principally relates to the use of the radio transmitting apparatus. Thus, for purposes of § 1031, the assigned frequency of the electromagnetic spectrum referred to in the television license is the sole underlying property to which the license relates.

CAVEAT:

A copy of this technical advice memornadum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

TECHNICAL ADVICE MEMORANDUM 200035005

Internal Revenue Service (I.R.S.)
Technical Advice Memorandum (TAM)
Issue: September 1, 2000
May 11, 2000

Section 1031 -- Exchange of Property Held for Productive Use or Investment

LEGEND:

Taxpayer
X
Y
Z
Date 1
Date 2
A
B
C
D
City P
City Q
City R
City S
$h
$i
$j
$k
$l
$m

ISSUE:

Whether the exchange of Federal Communications Commission (FCC) radio broadcast station licenses (radio licenses) for an FCC television broadcast station license (television license) is a like kind exchange subject to the nonrecognition rules under Section 1031 of the Internal Revenue Code.

CONCLUSION:

The exchange of FCC radio licenses for an FCC television license is a like kind exchange under Section 1031.

FACTS:

Taxpayer is the parent company of an affiliated group that files a consolidated return on a 52-53 week taxable year. X, a subsidiary that was a member of Taxpayer's consolidated group, entered into an asset exchange agreement on Date 1, with Y. Y was subsequently acquired by a consolidated group with Z as the parent company. Pursuant to the agreement, on Date 2, X transferred to Y radio station A in City P, radio station B in City Q, and radio station C in City R, and acquired from Y television station D in City S.

Taxpayer reported for financial reporting purposes that the television station acquired in the exchange had a fair market value of $h, while the radio stations surrendered in the exchange had a basis of $i. Taxpayer, therefore, reported a pre-tax, non-cash, non-operating gain of $j for financial reporting purposes. The FCC licenses represented the largest portion of the exchange with the FCC radio licenses valued at $k and the FCC television license valued at $llll.

For federal income tax purposes, Taxpayer treated the exchange of FCC radio licenses for the FCC television license as an exchange of like kind property under Section 1031(a). Taxpayer on its consolidated return reported a gain of approximately $m on the exchange, the difference between the reported values of the FCC radio licenses surrendered in the exchange and the FCC television license received in the exchange.

As part of the asset exchange agreement, X transferred tangible property to Y and received tangible property from Y. The bulk of such property was radio and television broadcasting equipment that was in the same product class as set forth in the 1987 Standard Industrial Classification ("SIC") Manual. That product class is SIC code number 3663, which is entitled "Radio and Television Broadcasting and Communications Equipment." Certain other equipment transferred by X and Y pursuant to the asset exchange agreement, including towers used to hold radio and television broadcast equipment, was in the same product class as set forth in the SIC Manual. For federal income tax purposes, Taxpayer treated the exchange of this tangible property as qualifying under Section 1031(a).

The Communications Act of 1934 (the "Communications Act") grants the FCC the power to license "radio stations." 47 U.S.C. Section 303(a) (1995 & 1999 Supp.). Under this grant of authority, the FCC licenses both radio and television broadcasting. FCC regulations define "radio station" as "[a]

separate transmitter or group of transmitters under simultaneous common control, including the necessary equipment required for carrying on a radio communications service." 47 C.F.R. Section 1,907. FCC regulations define "radio communication" to mean "[t]elecommunication by means of radio waves," which applies to both radio and television broadcasting. 47 C.F.R. Section 2.1. Thus, both radio and television are transmitted over the electromagnetic spectrum by radio transmitting equipment. The Communications Act further grants the FCC the power to "assign frequencies for each individual station and determine the power which each station shall use and the time during which it may operate." 47 U.S.C. Section 303(c) (1995 & 1999 Supp.).

The usable radio frequencies of the electromagnetic spectrum range from about 30,000 hertz to 30 gigahertz. Radio broadcasts can be transmitted over frequencies as low as 30 - 300 kilohertz (low frequency) to 300 - 3,000 megahertz (ultra high frequency, "UHF"). Television broadcasts can be transmitted over frequencies as low as 30 - 3000 megahertz (very high frequency, "VHF") to 300 - 3,000 megahertz (UHF). There are 12 VHF channels and 56 UHF channels.

The bandwidth of a radio frequency dictates the amount of information that the frequency can carry. Due to the complexity of a television signal, a much larger bandwidth is needed in comparison to an audio only signal. In the United States, a television channel occupies a width of six megacycles in the radio spectrum. This is 600 times as wide as the channel used by each standard sound broadcasting station.

The rights conferred upon holders of FCC licenses (both radio and television) are described in the FCC licenses themselves. Each of the licenses submitted by Taxpayer expressly states that "the licensee is hereby authorized to use and operate the radio transmitting apparatus herein described." More specifically, each of the FCC licenses confers a right to use the radio transmitting apparatus to broadcast on a designated channel and frequency range, at designated hours of operation, at designated geographic locations, at a maximum effective radiated power, and using antenna with certain antenna system specifications.

Section 301 of the Communication Act confirms that the licenses themselves confer the rights held by licensees.

Section 301 provides:

It is the purpose of this chapter, among other things, to maintain control of the United States over all the channels of radio transmission, and to provide for the use of such channels, but not the ownership thereof, by persons for limited periods of time, under licenses granted by Federal authority, and no such licenses shall be construed to create any right, beyond the terms, conditions, and periods of the license. 47 U.S.C. Section 301 (1995 & 1999 Supp.) (emphasis added).

The FCC licenses (both radio and television licenses) submitted by Taxpayer reflect the mandate of Section 301 in the following language:

This license shall not vest in the licensee any right to operate the station nor any right in the use of the frequency designated in the license beyond the term hereof, nor in any other manner than authorized herein.

Thus, the FCC licenses themselves contain the rights to use radio transmitting apparatus to broadcast programming (whether radio or television) over a portion of the electromagnetic spectrum at a certain power in a designated geographic area.

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. See also Section 1.1031(a)-1(a) of the Income Tax Regulations.

Section 1.1031(a)-1(b) provides that "like kind" refers to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under Section 1031, be exchanged for property of a different kind or class. See also Section 1.1031(a)-2(a).

Section 1.1031(a)-2(a) provides that personal properties of a like class are considered to be of a "like kind" for purposes of Section 1031. In addition, an exchange of properties of a like kind may qualify under Section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Under Section 1.1031(b), depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in Section 1.1031(a)- 2(b)(2)) or within the same Product Class (as defined in Section 1.1031(a)- 2(b)(3)).

Section 1.1031(a)-2(c)(1) provides generally that an exchange of intangible personal property or non-depreciable personal property qualifies for nonrecognition of gain or loss under Section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates. For example, an exchange of a copyright on a novel for a copyright on a different novel is a like kind exchange, but an exchange of a copyright on a novel for a copyright on a song is not a like kind exchange. Section 1.1031(a)- 2(c)(3).

In the instant case, the FCC radio licenses and the FCC television license are intangible personal property. Thus, the determination of whether they are like kind depends on (1) the nature or character of the rights involved; and (2) the nature or character of the underlying property to which the intangible personal property relates.

The Nature or Character of the Rights Involved

The FCC licenses at issue in this exchange are labeled either, "Television Broadcast Station License," "AM Broadcast Station License," or "FM Broadcast Station License." Taxpayer argues that, despite the labels, the rights granted in each license are virtually identical and that any differences are merely differences in grade or quality.

The example in the regulations regarding intangible property states that a copyright on a novel is like kind to a copyright on a different novel. See Section 1.1031(a)-2(c)(3). In this example, the determination that the copyrights are like kind is based, in part, on a comparison of the nature and character of the rights involved (the copyrights). In the case of a copyright, federal law gives the holder of the copyright certain rights regarding the copyrighted material. Thus, as to the first inquiry, the nature or character of the rights involved, one copyright generally will be like kind to another. In the instant case, the determination of whether the FCC radio licenses are like kind with the FCC television license depends, in part, on the nature or character of the rights involved (the licenses).

We think the nature or character of the rights involved should be determined by looking to the substance of the specific rights granted in the FCC licenses, and not merely the labels. These rights are granted by the federal government, which, on behalf of the public, manages and controls the use of the electromagnetic spectrum. The government delegates authority to the FCC to issue licenses to radio and television stations to use the electromagnetic spectrum for broadcasting purposes. An FCC license, whether for television or for radio, enables the licensee to broadcast programming to the public free of charge over the electromagnetic spectrum for the duration of the license. One FCC license will differ from another regarding the specific terms and conditions of operation. However, despite these differences, the rights conferred on an FCC licensee are basically the same.

An examination of the FCC licenses at issue reveals that each of the FCC licenses confers a right to use the referenced radio transmitting apparatus to broadcast on a designated channel and frequency range, at designated hours of operation, at designated geographic locations, at a maximum effective radiated power, and using antenna with certain antenna system specifications. This right is specifically enumerated in each FCC license, regardless of whether the license relates to a television station, an FM radio station, or an AM radio station. Other than the different labels, the only differences between the various FCC licenses are the specific operating parameters (such as frequency, operating hours, power, and antenna information) and geographic location. These differences do not change the nature or character of the rights granted in the licenses, but are merely differences in grade or quality.

The Nature or Character of the Underlying Property

Section 1031 also requires a comparison of the nature or character of the underlying property to which the intangible personal property relates. The example in the regulations states that a copyright on a novel is not like kind to a copyright on a song. See Â§ 1.1031(a)-2(c)(3). In that example, the underlying properties to which the copyrights relate are the novel and the song, since these are the properties protected by the copyrights. It is the fact that a novel and a song are not like kind that causes these two intangible properties to be not like kind. In the instant case, it is not as clear what property constitutes the underlying property to which the FCC licenses relate.

The agent contends that the exchange of the FCC licenses involves an exchange of a "bundle of rights" represented by the entire array of underlying tangible and intangible properties, which themselves must be examined on a case by case basis. Thus, in the agent's view, the property underlying the FCC license is all of the station's radio or television property. This property would include items such as programming content, advertising contracts, market growth, underdeveloped cable television markets, talent contracts, population base, favorable franchise fees, favorable systems performance, etc. The agent provides a detailed comparison of the various characteristics and assets of a radio station and a television station, and concludes that these characteristics and assets are very different. For example, unlike the television business where network affiliation is critical, most radio programming originates locally, and network affiliation has little effect on a radio station's competitive position.

Taxpayer, on the other hand, argues that the underlying property to which the licenses relate is the tangible personal property referred to in the licenses, i.e., the radio transmitting apparatus consisting of transmitters, towers, and antenna. Taxpayer asserts that this equipment is like kind because it is described in the same Product Class as in the SIC Manual. Taxpayer argues that the broadcasting equipment is the appropriate property to be examined for purposes of applying this prong of the like kind test for intangible property because this equipment is specifically referred to in the licenses themselves and thus, relates to the "essence" of the licenses.

We must reject the agent's argument as contrary to the approach generally taken in the regulations and revenue rulings, which require that, in determining whether an exchange of businesses qualifies as a like kind exchange, the underlying assets must be analyzed. See Section 1.1031(j)- 1(a) (requiring the use of exchange groups as an exception to the general rule that Section 1031 requires a property-by-property comparison); see also Rev. Rul. 89-121, 1989-2 C.B. 203 (the determination of whether Section 1031 applies to an exchange of the assets of one television station for another requires an analysis of the underlying assets exchanged); Rev. Rul. 72-151, 1972-1 C.B. 225 (when an exchange involves multiple assets, the fact that the assets in the aggregate comprise a business does not cause the exchange to be treated as a disposition of a single property for purposes of Section 1031). It is no more appropriate to look to the entirety of the assets comprising the radio or television station to determine what is the nature or character of the underlying property of an FCC license, on the grounds that the license is necessary to operate the television or radio station or is the single most valuable asset owned by the station, than it is to view the exchange of a radio or television station as the disposition of a single asset simply because those assets comprise a business or integrated economic investment. See Rev. Rul. 89-121.

A copyright for a novel would expressly reference the underlying novel and a copyright for a song would expressly reference the underlying song. Thus, we agree with Taxpayer's argument that the appropriate manner of identifying the underlying property is to look to the licenses themselves. However, we disagree that the radio transmitting apparatus described in the licenses should be considered the underlying property. Although the licenses specifically authorize Taxpayer to "use and operate the radio transmitting apparatus herein described," we think the license principally relates to the use of the radio transmitting apparatus, rather than the apparatus itself. An FCC license does not authorize the licensee to own or possess radio transmitting apparatus; the licensee would not need an FCC license for the apparatus unless it wanted to use that apparatus to broadcast over the electromagnetic spectrum. The FCC has the specific power to "assign frequencies for each individual station and determine the power which each

station shall use and the time during which it may operate." 47 U.S.C. Section 303(c) (1995 & 1999 Supp.). An FCC license reflects the FCC's decision to assign a specific frequency of the electromagnetic spectrum to a particular licensee in a given broadcast area. Thus, although an FCC license clearly regulates the manner in which the licensee may use its radio transmitting equipment, we think that the assigned frequency of the electromagnetic spectrum referred to in each license is the underlying property to which the license relates.

Having identified the property underlying an FCC license as the assigned broadcast frequency of the electromagnetic spectrum, we must determine whether the differences between a frequency assigned for television broadcasts and a frequency assigned for radio broadcasts are differences in nature or character or are merely differences in grade or quality.

Several courts have spoken to the meaning of the like kind standard. According to the Court of Appeals for the Fifth Circuit, "the distinction intended and made by the statute is the broad one between classes and characters of property, for instance, between real and personal property." Commissioner v. Crichton, 122 F.2d 181, 182 (5th Cir. 1941), aff'g 42 B.T.A. 490 (1940). The Tax Court has stated that "[t]he comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character." Koch v. Commissioner, 71 T.C. 54, 65 (1978), acq., 1979-1 C.B.1.

Published Service positions, particularly in the area of tangible personal property, have been more restrictive in interpreting the like kind standard. For example, compare Rev. Rul. 79-143, 1979-1 C.B. 264 (U.S. $20 gold coins, which are numismatic-type coins, are not like kind to South African Krugerrand gold coins, which are bullion-type coins), with Rev. Rul. 76-214, 1976-1 C.B. 218 (Mexican 50-peso gold coins and Austrian 100-corona gold coins, both of which are official government restrikes and noncurrency bullion-type coins, are like kind). See also California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982), aff'g 107 T.C. 107 (1981) (Tax Court did not err in refusing to apply the lenient treatment of real estate exchanges to an exchange of personal property involving U.S. Double Eagle $20 gold coins and Swiss francs). See generally Section 1.1031(a)-2(a) and (b), establishing additional rules for determining the like kind status of tangible depreciable personal property. These authorities indicate that functional differences between seemingly similar properties can be relevant in determining whether two properties are like kind. Similar concerns led Congress to clarify the like kind standard by enacting Section 1031(e), which provides that livestock of different sexes are not like kind. See S. Rep. No. 91-552, 91st Cong., 1st Sess. 102 (1969), 1969-3 C.B. 423, 488-489 (in typical cattle operation, male calves are castrated and sold for beef whereas female calves are used for breeding).

In comparing the nature or character of the frequency referred to in each FCC license, it is clear that there are differences between a radio frequency and a television frequency. As noted above, radio and television broadcasts are assigned to different frequency bands of the usable radio frequency spectrum. Television broadcasts require a considerably larger bandwidth than audio only radio broadcasts. Moreover, a licensee would be in violation of its license if it used a television frequency to broadcast radio transmissions and vice versa. However, even the narrowest interpretation of the like kind standard does not require that one property be identical to another or that they be completely interchangeable. Thus, we find that the differences in the assigned frequencies are not differences in nature or character, but are merely differences in grade or quality. Accordingly, Taxpayer's exchange of FCC radio licenses for an FCC television license qualifies as a like kind exchange under Section 1031.

This document may not be used or cited as precedent.

RELATED PARTY EXCHANGES

CAUTION NEEDED IN THESE TRANSACTIONS (ARTICLE)

INTENT OF THE RELATED PARTY RULES

The related party rules were enacted to prevent related parties from "cashing out" of an investment and avoiding tax if either party's property is disposed of within two years of the exchange. In addition, Section 1031(f) states that the Internal Revenue Service reserves the right to invalidate any exchange in which the taxpayer can't prove that the "exchange" did not have a principal purpose of avoiding taxes that would otherwise be due or avoiding the purposes of the related party rules.

WHO IS A RELATED PARTY?

A related party is any person or entity bearing a relationship with the taxpayer. Although not an exhaustive definition, this includes:

1. Family members such as brothers, sisters, spouses, ancestors and lineal descendents. (Stepparents, uncles, in-laws, cousins, nephews and ex-spouses are not considered related.)
2. A corporation or partnership in which more than 50% of the stock or more than 50% of the capital interest is owned by the taxpayer.

LET'S LOOK AT SEVERAL SCENARIOS

Allthough it is important to consult with tax or legal advisors before attempting any exchange with a related party, some guidelines exist which are useful in analyzing related party exchanges.

Simultaneous Exchange

When related parties directly swap with each other, both parties must hold the property acquired for two years following the exchange. If either party disposes of their property within the two year holding period, then the capital gain tax will need to be recognized.

Delayed – Selling to a Related Party

A taxpayer can sell to a related party, but the related party must hold the property for a minimum of two years or the exchange will be invalidated.

Delayed – Purchasing from a Related Party

A taxpayer should generally not purchase a replacement property from a related party. In Technical Advice Memorandum 9748006, the IRS disallowed tax deferral to a taxpayer who purchased his mother's property. Revenue Ruling 2002-83 also denied tax deferral treatment to an Exchanger using a Qualified Intermediary to ultimately purchase replacement property from a related party.

A conservative guideline to observe is: *"If the buyer and seller are related, and one of the parties ends up with the property and the other ends up with the cash, the exchange may be disallowed."*

RULES WHEN PURCHASING FROM A RELATED PARTY (ARTICLE)

Section 1031(f)(4) of the Code adds special rules for transactions between related persons. For purposes of Section 1031(f), the term "related person" means any person bearing a relationship to the Exchanger described in Section 267(b) or 707(b)(1). Essentially, Section 1031(f) denies tax deferral when related parties perform an exchange of low basis property for high basis property in anticipation of the sale of the high basis property. The rationale for Section 1031(f) is that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have essentially "cashed out" of the investment and the original exchange should not receive tax deferred treatment. The IRS tends to look at the related parties as a single economic unit and tax deferred exchange treatment will be disallowed if it is a part of a transaction or series of transactions structured to avoid the purposes of the related party provisions.

REVIEW OF RECENT LEGAL DEVELOPMENTS

TAM 102519-97: IRS ruled that an individual is not entitled to tax deferred treatment when purchasing a replacement property owned by a related party, even though a Qualified Intermediary (QI) purchased the replacement property.

TAM 200126007: IRS denies tax deferred treatment when Exchanger wanted to sell residential property with a low basis and exchange for replacement property owned by a party related to the Exchanger. The IRS felt this transaction involved "basis shifting" and a cashing out of the investment by an exchange between related parties.

FSA 199931002: Exchanger should not exchange into a property owned by a related party when transferring the relinquished property to an unrelated party.

FSA 2001137003: Exchanger can acquire a replacement property from a related party if the Exchanger and the related party are involved in a 'swap' and each hold their property for at least two years.

REVENUE RULING 2002-83

Revenue Ruling 2002-83 addresses the situation where an Exchanger transfers a relinquished property to a QI in exchange for a replacement property owned by a related party. The Revenue Ruling specifies that an Exchanger, under the facts shown below, is not entitled to nonrecognition treatment under Section 1031(a) if, as part of the transaction, the related party received cash or other non-like-kind property for the replacement property.

Facts:

- Exchanger A wants tax deferral under IRC Section 1031;
- B is an entity related to Exchanger A;
- C wants to buy A's property.

The Issue:

- Exchanger transfers low basis relinquished property to QI;
- QI sells relinquished property to C for cash;
- QI acquires high-basis replacement property from B, transfer this property to A and pays B the cash received from C.

Result: Tax Deferred Treatment Denied

In essence, the Exchanger A, enters into a like-kind exchange with QI, an unrelated thiry-party. The problem is that the end result is the same as if Exchanger A had exchanged property with B followed by a sale from B to C.

TERUYA BROTHERS V. COMM. AND PLR 2004-40002 (ARTICLE)

Teruya Brothers v. Comm. (2005)

The U.S. Tax Court held that a company could not defer gain under §1031 on its exchange of properties through a Qualified Intermediary that sold them and then later bought replacement properties from a party related to the exchanger because the company could not demonstrate that tax avoidance was not a principal purpose of the transaction.

The Section §1031 rules say that if someone exchanges with a related party, and the related party sells the property within two years, the transaction is disqualified from the tax deferral benefits of Section §1031.

Where Teruya Brothers Stumbled

When Teruya Brothers sold the Royal Towers Apartments and the Ocean Vista Condominiums in 1996, they did so through a §1031 exchange with a Qualified Intermediary. The Intermediary acquired the replacement property from Times Super Market, a Hawaii grocery chain, and then the Intermediary transferred the replacement property to Teruya Brothers, all in compliance with the 45-day and 180-day limits.

However, there was a problem: Teruya Brothers owned 62.5% of Times Super Market. Unfortunately for Teruya Brothers, the IRS has taken the position that this fact pattern is taxed as: 1) exchange of relinquished and replacement properties between the Teruya Brothers and Times Super Market, followed by 2) a sale to the third party by Times Super Market.

The court indicated that an exchange involving a Qualified Intermediary and a related party that did not involve tax avoidance might be valid in certain cases. In this case, the court found that tax avoidance was a principal purpose and disallowed the exchange.

PLR 2004-40002

This private letter ruling is important in that it validated a situation where related parties exchanged with each other where both performed a §1031 exchange and never cashed out of their investment.

Partnership A owned Building 1 and Partnership B owned Building 2. Partnership A and Partnership B are considered related persons under IRC Section §1031(f)(3). Partnership A had entered into a purchase and sale agreement to sell Building 1 to an unrelated third party and then purchase Building 2 from Partnership B in a §1031 exchange. Partnership B is also interested in doing a §1031 exchange on the sale of Building B as its relinquished property. Partnership B's replacement property is owned by a completely unrelated seller. Partnership A and Partnership B hire the same Qualified Intermediary to prepare all needed exchange documents. Partnerships A and B both represent they will not sell Building 2 or Partnership B's replacement property within 2 years from their acquisition in a §1031 exchange.

The IRS ruled that neither IRC §1031(f)(1) nor §1031(f)(4), with the tax avoidance structuring exception, apply since neither of the related persons are cashing out their investment and both partnerships are seeking to acquire like-kind replacement properties under IRC §1031.

TERUYA BROTHERS, LTD. & SUBSIDIARIES V. COMMISSIONER, 124 TC 45

Case Information: 124 T.C. No. 4

Code Sec(s):	1031
Docket:	Dkt. No. 17955-03.
Date Issued:	02/9/2005 .
Judge:	Opinion by Thornton, *J.*
Tax Year(s):	Year 1995.
Disposition:	Decision for Commissioner.

Counsel

Jonathan H. Steiner, William E. Bonano, and Stanley Y. Mukai, for petitioner.

Jonathan J. Ono, for respondent.

THORNTON, *Judge*

OPINION

Respondent determined a $4,144,359 deficiency in petitioner's Federal income tax for its taxable year ending March 31, 1996. The issue for decision is whether petitioner is entitled to defer gains realized on certain like-kind exchanges under section 1031(a) or must recognize gains under section 1031(f), which provides special rules governing exchanges between related persons. [1]

Background

This case is before us fully stipulated pursuant to Rule 122. We incorporate herein the stipulated facts. When peti-[pg. 46] tioner filed its petition, its principal place of business was in Honolulu, Hawaii.

Teruya Brothers, Ltd. (Teruya), is a Hawaii corporation. Its business activities include purchasing and developing residential and commercial real property. During the taxable year in issue, Teruya owned 62.5 percent of the common shares of Times Super Market, Ltd. (Times).

I. *Exchanges of Properties*

In 1995, Teruya engaged in two separate real property exchange transactions, referred to herein as the Ocean Vista transaction and the Royal Towers transaction.

A. *Ocean Vista Transaction*

Teruya owned a fee simple interest in Ocean Vista, a parcel of land underlying the Ocean Vista Condominium complex in Honolulu, Hawaii. Teruya's ownership interest in Ocean Vista was subject to a long-term ground lease held by Golden Century Investments Co. (Golden), which in turn was subject to a sublease held by the Association of Apartment Owners of Ocean Vista (the Association).

In March 1993, the Association inquired about buying Teruya's fee simple interest in Ocean Vista. Teruya responded that its fee simple interest in Ocean Vista was not available. Golden then proposed acquiring Ocean Vista as part of a like-kind exchange. In a letter of intent agreement, dated August 16, 1993, Golden agreed to purchase, and Teruya agreed to sell, Teruya's interest in Ocean Vista for $1,468,500. An amendment to the letter of intent, dated November 2, 1993, states: “It is understood and agreed that Teruya's obligation to sell Teruya's Interests to *** [Golden] is conditioned upon Teruya consummating a [section] 1031 tax deferred exchange of Teruya's interests.”

In June 1994, Teruya proposed buying Times's interest in “two pad sites” in Waipahu, Hawaii (these properties are hereinafter referred to collectively as Kupuohi II). Teruya's written proposal included these provisions:

The purchase will be subject to a [section] 1031 four party exchange.

Teruya may cancel the proposed purchase of *** [Times's] pad sites should the Ocean Vista transaction fail to proceed according to present plans.

Times accepted Teruya's proposal.

In a letter to Teruya and Golden, dated April 3, 1995, the Association offered to purchase Teruya's fee simple interest in Ocean Vista for $1,468,500. [2] Paragraph 9 of the offer to purchase states:

Tax-deferred Exchange. Teruya may, in its sole discretion, structure this transaction as a tax-deferred exchange pursuant to section 1031 of the Internal Revenue Code.

Paragraph 12 of the offer to purchase states:

Conditions Precedent. The following shall be conditions precedent to the closing of the transaction contemplated hereunder: ***
(h) Teruya shall be in a position to close on its exchange replacement properties.

On April 27, 1995, Teruya's board of directors accepted the Association's offer.

In August 1995, Teruya entered into an "exchange agreement" with T.G. Exchange, Inc. (TGE), whereby TGE agreed to act as an "exchange party to complete the exchange" of Ocean Vista for replacement property to be designated by Teruya, with the stated purpose of qualifying the exchange under section 1031. TGE agreed to acquire the replacement property with proceeds from the sale of Ocean Vista and additional funds from Teruya as necessary to effect the acquisition. Paragraph 6 of the exchange agreement states:

Notwithstanding the foregoing, if *** [Teruya] is unable to locate suitable Replacement Property by the date specified in the Acquisition Agreement [for Ocean Vista], then the Acquisition Agreement and this Exchange Agreement shall be terminated and the parties shall have no further obligations to each other *** .

Pursuant to the exchange agreement, Teruya transferred Ocean Vista to TGE, and on September 1, 1995, TGE sold Ocean Vista to the Association for $1,468,500. At that time, Teruya had a $93,270 basis in Ocean Vista.
Also on September 1, 1995, TGE applied the proceeds from the sale of Ocean Vista, as well as $1,366,056 in additional cash from Teruya, to acquire Kupuohi II from Times for [pg. 48] $2,828,000. Times had a $1,475,361 adjusted basis in Kupuohi II and recognized a $1,352,639 gain on the sale. [3]

At some point, TGE transferred Kupuohi II to Teruya. As of the date the petition was filed, Teruya still owned Kupuohi II.

B. *Royal Towers Transaction*

In 1994, Teruya owned a fee simple interest in the Royal Towers Apartment building (Royal Towers) in Honolulu, Hawaii. On or about December 12, 1994, Teruya and Savio Development Co. (Savio) entered into a $13.5 million contract for the sale of Royal Towers. The contract stated that the sale was subject to the "Seller [Teruya] being able to consummate [a section 1031] exchange." Teruya and Savio later agreed to decrease the price for Royal Towers from $13.5 million to $11,932,000. In April 1995, Teruya's board of directors approved the sale of Royal Towers to Savio.

In anticipation of Teruya's sale of Royal Towers, Teruya and Times previously had agreed that Teruya would purchase Times's interests in two parcels of real property in Waipahu and Aiea, Hawaii (respectively, Kupuohi I and Kaahumanu). One of the purchase terms stated:

The purchase will be subject to a [section] 1031 four party exchange.
***
Teruya may cancel the proposed purchase should the sale of the Royal Towers apartment fail to proceed according to present plans.

Early in 1995, the boards of directors of Times and Teruya approved the sale and purchase of Kupuohi I for $8.9 million and Kaahumanu for $3.73 million.

In August 1995, Teruya entered into an "exchange agreement" with TGE, whereby TGE agreed to act as an "exchange party to complete the exchange" of Royal Towers for replacement property to be designated by Teruya, with the stated purpose of qualifying the exchange under section 1031. TGE agreed to acquire the replacement property with proceeds from the sale of Royal Towers and additional funds from [pg. 49] Teruya as necessary to effect the acquisition. Paragraph 6 of the exchange agreement states:

Notwithstanding the foregoing, if *** [Teruya] is unable to locate suitable Replacement Property by the date specified in the Acquisition Agreement [for Royal Towers], then the Acquisition Agreement and this Exchange Agreement shall be terminated and the parties shall have no further obligations to each other *** .

Teruya transferred Royal Towers to TGE, and on August 24, 1995, TGE sold Royal Towers to Savio for $11,932,000. At that time, Teruya had a $670,506 basis in Royal Towers.

Also, on August 24, 1995, TGE applied the proceeds from the sale of Royal Towers, as well as $724,554 in additional funds from Teruya, to acquire Kupuohi I and Kaahumanu from Times for $8.9 million and $3.73 million, respectively. [4] At the time of the sales, Times had a $15,602,152 adjusted basis in Kupuohi I and a $1,502,960 adjusted basis in Kaahumanu. Times realized a $6,453,372 capital loss on the sale of Kupuohi I but did not recognize this loss on its tax return because of the restriction on transactions between related taxpayers under section 267. [5] Times realized and recognized a $2,227,040 gain on the sale of Kaahumanu.

At some point, TGE transferred Kupuohi I and Kaahumanu to Teruya. As of the date the petition was filed, Teruya still owned these properties.
II. *Federal Income Tax Return*

Petitioner filed Form 1120, U.S. Corporation Income Tax Return, for its taxable year beginning April 1, 1995, and ending March 31, 1996. Under section 1031(a)(1), petitioner deferred $1,345,169 in realized gain from the Ocean Vista transaction (after deducting claimed selling expenses of $30,061) and $10,700,878 in realized gain from the Royal Towers transaction (after deducting claimed selling expenses of $560,616). [pg. 50]

III. *Notice of Deficiency*

In the notice of deficiency, respondent determined that petitioner must recognize $12,041,026 in gains, which consists of the gains that Teruya deferred on its Federal income tax return for its taxable year ending March 31, 1996. [6]

Discussion

This case presents an issue of first impression regarding the application of section 1031(f), which restricts nonrecognition of gain or loss with respect to like-kind exchanges between related persons. [7]

I. *General Requirements for Like-Kind Exchanges*

Section 1031(a)(1) generally provides that no gain or loss shall be recognized on the exchange of like-kind properties held for productive use in a trade or business or for investment. Under certain conditions, a taxpayer's nonsimultaneous transfer and receipt of like-kind properties may qualify for section 1031 treatment, provided generally that the taxpayer identifies the new property within 45 days and receives it within 180 days of transferring the old property. See sec. 1031(a)(3). To facilitate such a deferred exchange, the taxpayer may use a qualified intermediary; i.e., a person who is not the taxpayer, an agent of the taxpayer, a related person to the taxpayer, or a related person to an agent of the taxpayer, see sec. 1.1031(k)-1(k), Income Tax Regs., who enters into a written exchange agreement with the taxpayer and, as required by this agreement, acquires property from the taxpayer, transfers this property, acquires like-kind replacement property, and transfers this replacement property to the taxpayer. Sec. 1.1031(k)-1(g)(4)(iii), Income Tax Regs.

Teruya used a qualified intermediary, TGE, to facilitate its transfers of Ocean Vista and Royal Towers and its acquisitions of Kupuohi II, Kupuohi I, and Kaahumanu. Respondent does not dispute that these transactions meet the general [pg. 51] requirements for like-kind exchanges under section 1031(a)(1). Respondent contends, however, that section 1031(f) requires petitioner to recognize gains on the transactions.

II. *Rules Applicable to Related-Person Exchanges*

Section 1031(f)(1) provides generally that if a taxpayer and a related person exchange like-kind property and within 2 years either one disposes of the exchanged property, the nonrecognition provisions of section 1031(a) do not apply. Instead, any gain or loss must be taken into account as of the date of the disposition. As one of the few enumerated exceptions to this rule, section 1031(f)(2)(C) provides that a disposition of exchanged property will not be taken into account if "it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax." [8]

It is undisputed that Times and Teruya were related persons within the meaning of the statute. [9] Respondent makes no argument, however, that section 1031(f)(1) applies directly to the Ocean Vista and Royal Towers transactions. [10] Instead, respondent argues that petitioner has run afoul of section 1031(f)(4), which provides: "This section [1031] shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection [(f)]." Inasmuch as the statute does not directly identify or describe the purposes of subsection (f), we turn our attention to the legislative history.

III. *Legislative History: Purposes of Section 1031(f)*
Property acquired in a like-kind exchange generally takes the basis of the property relinquished. See sec. 1031(d). In other words, there is a "shifting" of tax basis between the [pg. 52] relinquished property and the replacement property. See H. Conf. Rept. 101-386, at 613 (1989).

Before 1989, Congress was concerned that because of this basis-shifting effect, "related parties *** 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." H. Rept. 101-247, at 1340 (1989). In effect, because of basis shifting, related persons were able to "cash out" of their investments in property having an inherent gain at relatively little or no tax cost. See id. Also, in some cases, basis shifting allowed related persons to accelerate a loss on property that they ultimately retained. See id. Responding to these perceived abuses, Congress concluded 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." Id. This policy is reflected in section 1031(f), as enacted in the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, sec. 7601(a), 103 Stat. 2370.

Congress was also concerned that related persons not be able to circumvent the purposes of this rule by using an unrelated third party:

Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. [H. Rept. 101-247, supra at 1341.]

Equating a qualified intermediary with the "unrelated party" referred to in the above- quoted example, respondent reads the example to mean that a deferred exchange between related parties, involving a qualified intermediary, should be recast as a direct exchange between the related parties. If section 1031(f)(1) would preclude nonrecognition treatment for the recast transaction, respondent concludes, then the deferred exchange should be deemed to have been structured to avoid the purposes of section 1031(f). Respondent suggests [pg. 53] that such an analysis ends the inquiry under section 1031(f)(4).

Although respondent's argument has superficial appeal, it is only loosely grounded in the above-quoted, highly elliptical example in the legislative history. Cf. Mandarino, "Reconciling Rulings on Related Party Like-Kind Exchanges", 30 Real Estate Taxn. 174, 175 (Third Quarter 2003) ("Because of the way this example is drafted, it appears not to make the point for which it is offered."). Moreover, respondent's analysis fails to consider the

non-tax-avoidance exception of section 1031(f)(2)(C). [11] Because this exception is subsumed within the purposes of section 1031(f), any inquiry into whether a transaction is structured to avoid the purposes of section 1031(f) should also take this exception into consideration.

Petitioner seems to suggest that Congress intended section 1031(f) to apply only insofar as the taxpayer fails to "continue its investment" in property that it receives in a related- person deferred exchange. Petitioner seems to suggest that what happens to the relinquished property is of no consequence. We reject any such suggestion as flatly contrary to section 1031(f), which applies with equal force to postexchange dispositions by either the taxpayer or the related person.

IV. *Analysis of the Ocean View and Royal Towers Transactions*

Teruya exchanged Ocean View and Royal Towers for like-kind replacement properties formerly owned by Times. A qualified intermediary immediately sold Ocean Vista and Royal Towers to unrelated third parties. Times received the proceeds, plus additional cash from Teruya.

These transactions are economically equivalent to direct exchanges of properties between Teruya and Times (with boot from Teruya to Times), followed by Times's sales of the properties to unrelated third parties. The interposition of a qualified intermediary in these transactions cannot obscure the end result. Petitioner offers no explanation for structuring the Ocean Vista and Royal Towers transactions as it did, and the record discloses no reason (other than seeking to [pg. 54] avoid the section 1031(f) rules) for Teruya's using a qualified intermediary to accomplish the transactions. Under the circumstances, we are led to the conclusion that Teruya used the multiparty structures to avoid the consequences of economically equivalent direct exchanges with Times. As discussed below, petitioner has failed to establish that avoidance of Federal income taxes was not one of the principal purposes of the Ocean Vista and Royal Towers transactions.

V. *Non-Tax-Avoidance Exception*

Petitioner argues that Teruya's continued investment in like-kind properties meets the requirements of the non-tax-avoidance exception under section 1031(f)(2)(C), as subsumed within section 1031(f)(4). Section 1031(f)(2)(C) provides that there shall not be taken into account any disposition "with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax." [12]
With respect to both the Ocean Vista and Royal Towers transactions, petitioner contends that "there was no intent to disguise an actual sale of the relinquished property in order to reduce or avoid gain recognition on such sale, *because a sale of the relinquished property was not intended in the first place*." In other words, petitioner contends that from the outset of both transactions, Teruya intended to qualify for deferred like-kind exchange treatment and did not intend to make direct sales of the properties. Petitioner points to the fact that Teruya, Times, Golden, the Association, and Savio agreed in various documents that the Ocean Vista and Royal Towers transactions were conditional on effecting a section 1031 exchange.

Petitioner's contentions might be relevant in determining whether a transaction is in substance an exchange or a sale of like-kind property. See Alderson v. Commissioner, 317 F.2d 790 [11 AFTR 2d 1529] (9th Cir. 1963), revg. 38 T.C. 215 (1962). In the instant case, however, they have little relevance. In the first instance, respondent does not contend that the transactions in question were disguised sales or otherwise fail to meet the [pg. 55] general requirements of section 1031(a)(1). More fundamentally, section 1031(f) presupposes that an exchange to which it applies otherwise meets the requirements of section 1031(a)(1). See sec. 1031(f)(1)(B). Even if Teruya never intended to make a direct sale of the relinquished properties, this does not mean that section 1031(f) is not implicated or that the deferred sale was not structured so as to avoid Federal income taxes. The economic substance of the transactions remains that the investments in Ocean Vista and Royal Towers were cashed out immediately and Times, a related person, ended up with the cash proceeds.

With respect to the Ocean Vista transaction, petitioner contends that there was no tax avoidance purpose because Times recognized a gain on its sale of Kupuohi II ($1,352,639) that was larger than the gain Teruya would have recognized ($1,345,169) had it sold Ocean Vista directly to the Association for cash. [13] Although Times recognized a gain in the Ocean Vista transaction that slightly exceeded Teruya's gain deferral, it appears that Times paid a much smaller tax price for that gain recognition than Teruya would have paid if it had recognized gain in a direct sale of Ocean Vista. On its corporate income tax return for taxable year ending March 31, 1996, Teruya reported taxable income of $2,060,806. Consequently, if Teruya had made a direct sale of Ocean Vista, the gain recognized on that sale presumably would have been taxable at a 34-percent corporate income tax rate. See sec. 11(b)(1)(C). By comparison, on its Form 1120 for its taxable year ending April 25, 1996, Times reported a net operating loss (NOL) of $1,043,829. Thus, although Times recognized a considerable gain on the Ocean Vista transaction, because of offsetting expenses, it did not incur tax on that gain. Instead, the only tax consequences of Times's gain recognition were reductions of its NOL for its taxable year ending April 25, 1996, and of its NOL carryovers for subsequent taxable years.

In sum, petitioner has failed to persuade us that avoidance of Federal income tax was not one of the principal purposes of the Ocean Vista and Royal Towers transactions. [pg. 56]

VI. *Conclusion*

Petitioner offers no explanation for Teruya's use of the qualified intermediary in the Ocean Vista and Royal Towers transactions. We infer that the qualified intermediary was interposed in an attempt to circumvent the section 1031(f)(1) limitations that would have applied to exchanges directly between related persons. Petitioner has failed to show that avoidance of Federal income tax was not one of the principal purposes of the Ocean Vista and Royal Towers transactions. We conclude that these transactions were structured to avoid the purposes of section 1031(f). Consequently, petitioner is not entitled, under section 1031(a)(1), to defer the gains that it realized on the exchanges of Ocean Vista and Royal Towers. [14]

An appropriate order will be issued denying petitioner's motion to supplement the record, and decision will be entered for respondent.

[1]

Section references are to the Internal Revenue Code in effect for the taxable year in issue and as amended. Rule references are to the Tax Court Rules of Practice and Procedure.

[2]

On June 14, 1994, Teruya, Golden, and the Association executed an "Assignment, Assumption and Release", wherein the Association was substituted as a party in place of Golden.

[3]

The parties have stipulated that Times had a $1,475,633 basis in Kupuohi II at the time of its sale; however, this number yields computational inconsistencies with respect to other numerical stipulations. To avoid these inconsistencies, we have found Times's adjusted basis in Kupuohi II to be $1,475,361, which is the number reflected on Times's 1995 corporate income tax return.

[4]

The proceeds from the sale of Royal Towers ($11,932,000) and the additional funds from Teruya ($724,554) total $12,656,554. The agreed sale price for Kupuohi I ($8.9 million) and Kaahumanu ($3.73 million), however, totaled $12,630,000. The parties do not explain this seeming discrepancy.

[5]

The parties stipulated the $6,453,372 realized capital loss on the sale of Kupuohi I; however, on the basis of the $8.9 million sale price and the $15,602,152 adjusted basis that the parties stipulated, it appears that the loss realized was actually $6,702,152. The parties do not address this seeming discrepancy.

[6]

The deferred gains from the Ocean Vista and Royal Towers transactions that the parties stipulated total $12,046,047. The parties do not explain the seeming discrepancy between this figure and the $12,041,026 adjustment in the notice of deficiency.

[7]

The examination in this case commenced in November 1997. Consequently, the burden of proof rule of sec. 7491(a)(1) does not apply. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, sec. 3001(c), 112 Stat. 727.

[8]

Other exceptions, not implicated here, apply to dispositions after the death of the taxpayer or related party, see sec. 1031(f)(2)(A), and to involuntary conversions, see sec. 1031(f)(2)(B).

[9]

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

[10]

Respondent appears to acknowledge implicitly that sec. 1031(f)(1) applies only in the case of a *direct* exchange between related persons and that this case does not involve such a direct exchange. Consistent with such a view, the regulations provide that a "qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a)." Sec. 1.1031(k)-1(g)(4)(i), Income Tax Regs.

[11]

As previously discussed, in the context of a direct exchange between related parties, sec. 1031(f)(2)(C) allows the taxpayer to establish that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax.

[12]

In other contexts involving similar language, we have applied a "strong proof" standard. See, e.g., Schoneberger v. Commissioner, 74 T.C. 1016, 1024 (1980). Because it makes no difference to the outcome of this case, we do not apply any heightened standard of proof.

[13]

The $1,345,169 figure includes approximately $30,061 in claimed selling expenses that Teruya deducted in computing its sec. 1031(a) deferral. Petitioner assumes that Teruya would have incurred these same selling expenses in a direct sale of Ocean Vista.

[14]

On Sept. 8, 2004, petitioner filed a motion to supplement the record with three letters from respondent to petitioner. Each of these letters concerns a technical advice memorandum that involves a multiparty transaction among a taxpayer, a qualified intermediary, and a related person. In a rambling 96-page reply brief, petitioner contends that these letters provide an abundance of evidence that respondent has been improperly administering sec. 1031(f)(4). Because we find that the letters petitioner submitted have no relevance to the issues in this case, we will deny petitioner's motion to supplement the record.

REVENUE RULING 2002-83

ISSUE

Under the facts described below, is a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party entitled to nonrecognition treatment under § 1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other nonlike-kind property for the replacement property?

FACTS

Individual A owns real property (Property 1) with a fair market value of $150x and an adjusted basis of $50x. Individual B owns real property (Property 2) with a fair market value of $150x and an adjusted basis of $150x. Both Property 1 and Property 2 are held for investment within the meaning of § 1031(a). A and B are related persons within the meaning of § 267(b).

C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B.

Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for $150x. On January 13, 2003, QI acquires Property 2 from B, pays B the $150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

LAW AND ANALYSIS

Section 1031(a)(1) provides 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 the property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment. Under § 1031(d), the basis of property acquired in a § 1031 exchange is the same as the basis of the property exchanged, decreased by any money the taxpayer receives and increased by any gain the taxpayer recognizes.

Section 1031 and the regulations thereunder allow for deferred exchanges of property. Under § 1031(a)(3) and § 1.1031(k)– 1(b) of the Income Tax Regulations, however, the property to be received by a taxpayer in the exchange (replacement property) must be: (i) identified within 45 days of the transfer of the property relinquished in the exchange (relinquished property) and (ii) received by the earlier of 180 days after the transfer of the relinquished property or the due date (including extensions) of the transferor's tax return for the taxable year in which the relinquished property is transferred.

Section 1.1031(k)–1(g)(4) allows taxpayers to use a qualified intermediary to facilitate a like-kind exchange. In the case of a transfer of relinquished property involving a qualified intermediary, the taxpayer's transfer of relinquished property to a qualified intermediary and subsequent receipt of like-kind replacement property from the qualified intermediary is treated as an exchange with the qualified intermediary.

Section 1031(f) provides special rules for property exchanges between related parties. Under § 1031(f)(1), a taxpayer exchanging like-kind property with a related person cannot use the nonrecognition provisions of § 1031 if, within 2 years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. The taxpayer takes any gain or loss into account in the taxable year in which the disposition occurs. For purposes of § 1031(f), the term "related person" means any person bearing a relationship to the taxpayer described in § 267(b) or 707(b)(1).

Section 1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The legislative history underlying § 1031(f) states 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 st Cong. 1 st Sess. 1340 (1989).

To prevent related parties from circumventing the rules of § 1031(f)(1), § 1031(f)(4) provides that the nonrecognition provisions of § 1031 do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1). The legislative history underlying § 1031(f)(4) provides:

If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. *Id.* at 1341.

Accordingly, under § 1031(f)(4), if an unrelated third party is used to circumvent the purposes of the related party rule in § 1031(f), the nonrecognition provisions of § 1031 do not apply to the transaction.

In the present case, A is using QI to circumvent the purposes of § 1031(f) in the same way that the unrelated party was used to circumvent the purposes of § 1031(f) in the legislative history example. Absent § 1031(f)(1), A could have engaged in a like-kind exchange of Property 1 for Property 2 with B, and B could have sold Property 1 to C. Under § 1031(f)(1), however, the non-recognition provisions of § 1031(a) do not apply to that exchange because A and B are related parties and B sells the replacement property within 2 years of the exchange.

Accordingly, to avoid the application of § 1031(f)(1), A transfers low-basis Property 1 to QI who sells it to C for cash. QI acquires the high-basis replacement property from B and pays B the cash received from C. Thus, A engages in a like-kind exchange with QI, an unrelated third party, instead

of B. However, the end result of the transaction is the same as if A had exchanged property with B followed by a sale from B to C. This series of transactions allows A to effectively cash out of the investment in Property 1 without the recognition of gain.

A's exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of § 1031(f) and, under § 1031(f)(4), the non-recognition provisions of § 1031 do not apply to the exchange between A and QI. A's exchange of Property 1 for Property 2 is treated as a taxable transaction. Under § 1001(a), A has gain of $100x, the difference between A's amount realized on the exchange ($150x, the fair market value of Property 2) and A's adjusted basis in the property exchanged ($50x).

HOLDING

Under the facts described above, a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

DRAFTING INFORMATION

The principal author of this revenue ruling is Martin Scully, Jr., of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Scully at (202) 622–4960 (not a toll-free call).

PRIVATE LETTER RULING 200730002

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: July 27, 2007
April 26, 2007

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Taxpayer =
Brother =
Deceased Brother =
Niece =
Country X =
State Y =
City Z =
Blackacre =
Greenacre =
Year 1 =
Year 2 =
Date 3 =
$6 =
$3 =

Dear ***:

This responds to your request for a private letter ruling dated January 29, 2007. Specifically, you are asking for a ruling that Section 1031(f) of the Internal Revenue Code does not apply to trigger recognition of gain realized in a proposed exchange of like-kind properties.

FACTS:

The proposed transaction is an exchange of partial interests in two parcels of real property between related persons and the sale of one of those parcels to City Z within two years of the exchange. Parties to the proposed transaction are Taxpayer, Brother, an irrevocable trust of Deceased Brother (Trust) and Niece, who is the daughter of Deceased Brother and sole beneficiary of Trust. Taxpayer is trustee of said Trust. Niece is a resident of Country X. Taxpayer and Brother are residents of State Y. Taxpayer, Brother and Trust are equal tenants in common of Blackacre and Greenacre (sometimes referred to as "Properties") located in City Z.

Taxpayer, Brother and Deceased Brother inherited the Properties on the death of their mother in Year 1. Later, Deceased Brother transferred his interest in the Properties to a revocable intervivos trust. This was a grantor trust for federal income tax purposes so that he remained a part owner of the Properties for federal income tax purposes.

Deceased Brother died in Year 2. Under Article II.B. of the Trust Declaration, nearly all of Deceased Brother's estate, including his interest in the Properties, was to be distributed outright and free of trust to Niece. However, difficulties involved in dealing with the undivided interests in the Properties have delayed the distribution of the Properties from Trust.

Taxpayer has been the trustee of Trust and has been managing the properties for all three owners. Prior to the exchange and sale described below, Taxpayer will resign as trustee. Under Article VI.A. of the Trust Declaration, Niece will become successor trustee upon the resignation of Taxpayer. Therefore, at the time of the exchange and sale, Taxpayer will have no fiduciary or Section 267(b) relationship to Niece or the Trust. Niece, as trustee of Trust and as the sole beneficiary will be both the legal and beneficial owner of the Trust's interest in the two Properties. Additionally, Niece is already entitled to immediate distribution of the Trust Corpus. Thus, for purposes of this ruling, Niece is treated as a one-third owner of the Properties.

Brother and Niece want to sell the Properties and use their share of the sale proceeds for other investment and personal purposes. Taxpayer prefers to remain invested in real estate, preferably in one of the Properties, but wishes to be relieved of the burden of managing the Properties for the benefit of Brother and Niece. Accordingly, Taxpayer sought buyers for the Properties. City Z expressed interest in acquiring both Properties or in acquiring Greenacre alone. On Date 3, representatives of City Z endorsed a nonbinding letter of intent to purchase Greenacre for $6 and to cooperate with sellers in structuring the transaction as a Section 1031 exchange.

Greenacre's fair market value is $6 and Blackacre's is about $3. Thus, each of the owner's 1/3 interest in the combined Properties is worth about $3, the one-third interest each has in Greenacre being worth about $2 and the one-third each has in Blackacre, about $1. Taxpayer, Brother and Niece have agreed that Taxpayer will exchange his one-third interest in Greenacre (worth approximately $2) for Brother's and Niece's combined two-third interest in Blackacre (worth approximately $2), the "exchange" referred to in the ruling request. Following the exchange, Brother and Niece would each own one-half of Greenacre (each half worth $3). They would then sell that property to City Z for $6 and split the proceeds. Taxpayer will retain full ownership of Blackacre (worth about $3) and continue renting it to commercial tenants.

APPLICABLE LAW:

Section 1031(a)(1) provides 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 that if –

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange –

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer, there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

Section 1031(f)(2) provides that for purposes of paragraph (1)(C), there shall not be taken into account any disposition –

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of Â§ 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax.

Section 1031(f)(3) provides that for purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in Sections 267(b) or 707(b)(1).

Relationships described in Section 267(b) include members of a family, as defined in Section 267(c)(4), and a fiduciary of a trust and a beneficiary of such trust. Section 267(c)(4) provides that the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

The Senate Finance Committee Report, S. Prt, No. 56, 101st Cong., 1st Sess., 151 (1989) for the Revenue Reconciliation Act of 1989 (P.L. 101-239) (the Report) states, in part:

A disposition also will not invalidate the nonrecognition treatment of the original exchange if it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of [f]ederal income tax. It is intended that the non-tax avoidance exception generally will apply to: (i) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either an entire interest in a single property or a larger undivided interest in any of such properties...

The Conference Committee adopted the Senate Amendment. H.R. Rep. No. 386, 101st Cong., 1st Sess. 613 (1989).

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 this subsection.

LEGAL ANALYSIS and CONCLUSION:

Taxpayer and Brother are related persons under Section 267(b)(1) and (c)(4). Also, Taxpayer, prior to his resignation as trustee of Trust, and Niece are related persons under Section 267(b)(6) because Taxpayer is the trustee of the trust holding title to undivided interests in the Properties and Niece is the beneficiary of that Trust. In addition, the sale to City Z of some of the property exchanged (Greenacre) will occur within two years of the exchange. Accordingly, the sale to City Z of Greenacre is a disposition described in Section 1031(f)(1)(C).

As discussed above, a disposition described in Section 1031(f)(1)(C) results in recognition of gain unless the disposition is described in Section 1031(f)(2), including Section 1031(f)(2)(C), which describes a situation where neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of tax. In the present case, prior to the disposition of Greenacre to City Z, there will be an exchange of undivided interests in which the exchanging parties receive either a whole interest in property or a larger undivided interest in property. According to the legislative history underlying Section 1031(f), Congress intended that the non-tax avoidance exception of Section 1031(f)(2)C) apply to this specific circumstance involving an exchange of undivided interests in different properties that results in each taxpayer holding either an entire interest in a single property or a larger undivided interest in any of such properties. Consequently, the parties in the present case do not have (or are deemed to

not have) the intent to avoid the federal income tax by the exchange of their undivided interest and subsequent sale of some of the interests being exchanged within two years.

In addition, the conclusion that the parties do not have (or are deemed to not have) the intent to avoid federal income tax has a natural corollary that the transaction (or series of transactions) was not structured to avoid the purposes of Section 1031(f). Brother's basis in the Properties is lower than Taxpayer's basis so it is not in the related parties' interest for Brother, rather than Taxpayer, to sell his interest in the Properties. See Rev. Rul. 2002-83, 2002-2 C.B. 927. Further, had the distribution of Properties to Niece occurred as intended on the death of Deceased Brother in Year 2, there would have been no related party issue with respect to Niece under Section 1031(f) because Niece and Taxpayer would not have been related persons. The same would be true if Taxpayer resigns as successor trustee, as provided in the original trust agreement, at or near the time of the exchange. Accordingly, we rule as follows:

1. Taxpayer's exchange of his one-third interest in Greenacre, for Brother's and Trust's (Niece's) two-third interest in Blackacre will not be for the principal purpose of avoidance of federal income tax within the meaning of Section 1031(f)(2)(C).

2. The transactions describe in this ruling are not structured to avoid the purposes of Section 1031(f) within the meaning of Section 1031(f)(4).

CAVEAT(S):

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under Â§ 6110. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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

PRIVATE LETTER RULING 200728008

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: July 13, 2007
April 12, 2007

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

Taxpayer =
Taxpayer's ID =
Related Party =
QI =
EAT =
A LLC =
B LLC =
C LLC =
$D =
$E =
$F =
Replacement Property # 1 =
Relinquished Property # 1 =
Replacement Property # 2 =
Relinquished Property # 2 =

Dear *** :

This letter responds to your ruling request submitted on behalf of Taxpayer by letter dated January 26, 2007 as to whether nonrecognition treatment under Section 1031(a) of the Internal Revenue Code would apply to its transfers of real properties in multi-party exchanges involving a related party and a qualified intermediary.

STATEMENT OF FACTS

We rely on the facts and conditions set forth in Taxpayer's submissions dated January 26, 2007 and March 7, 2007.

Taxpayer and Related Party are related persons within the meaning of Section 1031(f)(3). Taxpayer transferred its properties, Relinquished Property # 1 and Relinquished Property # 2, and acquired Replacement Property # 1 and Replacement Property # 2 in two separate transactions. In the first transaction, Taxpayer wished to exchange Relinquished Property # 1 for Replacement Property # 1, which was owned by a party unrelated to Taxpayer, through a reverse like-kind exchange. Taxpayer represents that Relinquished Property # 1 is like-kind to Replacement Property # 1 within the meaning of Section 1031(a) and Section 1.1031(a)-1(b). To facilitate this exchange, Taxpayer entered into the following transactions pursuant to a qualified exchange accommodation arrangement ("QEAA") set forth in Rev. Proc. 2000-37, 2000-2 C.B. 308, as modified by Rev. Proc. 2004-51, 2004-2 C.B. 294: (1) Taxpayer loaned $D to EAT to purchase Replacement Property # 1; (2) EAT purchased Replacement Property # 1 for $D from the unrelated party; (3) the unrelated party transferred Replacement Property # 1 to A LLC, which is a wholly-owned, single-member limited liability company of EAT; (4) Taxpayer transferred Relinquished Property # 1 to Related Party for Relinquished Property # 1's fair market value, $E; (5) Related Party transferred $E to QI, which is an affiliate of EAT; and (5) QI transferred Replacement Property # 1 (by transferring A LLC, which owned Replacement Property # 1) to Taxpayer.

EAT functioned as an exchange accommodation titleholder. QI is a qualified intermediary described in Section 1.1031(k)-1(g)(4) and not a "disqualified person" with respect to Taxpayer within the meaning of Section 1.1031(k)-1(k). Because A LLC is a disregarded entity for Federal tax purposes, a transfer of A LLC is treated as a transfer of the assets of A LLC.

The value of Relinquished Property # 1 was lower than the value of Replacement Property # 1. Accordingly, Taxpayer sold other like-kind properties through QI to other unrelated parties to cover the difference between $D and $E. QI then repaid the $D loan from Taxpayer that was used by EAT to purchase Replacement Property # 1.

In the second transaction, Taxpayer wished to exchange Relinquished Property # 2 for Replacement Property # 2, which was owned by an unrelated party, through a like-kind exchange. Taxpayer represents that Relinquished Property # 2 is like-kind to Replacement Property # 2 within the meaning of Section 1031(a) and Section 1.1031(a)-1(b). Taxpayer entered into the following transactions: (1) Taxpayer transferred Relinquished Property # 2 to Related Party by transferring B LLC and C LLC, both single-member limited liability companies, that jointly owned Relinquished Property # 2; (2) Related Party paid the fair market value of Relinquished Property # 2 in the amount of $F to QI; (3) QI used $F to acquire Replacement Property # 2 from a party unrelated to Taxpayer; and (4) QI transferred Replacement Property # 2 to Taxpayer.

After the above-transactions, Taxpayer held Replacement Property # 1 and Replacement Property # 2, and Related Party held Relinquished Property # 1 and Relinquished Property # 2. Related Party intends to dispose of Relinquished Property # 1 and Relinquished Property # 2 within two years of the receipts.

LAW AND ANALYSIS

Applicable Requirements for Deferral under Section 1031.

Section 1031 was initially promulgated to avoid taxing gains that were mere "paper profits," i.e., the taxpayer had realized nothing tangible and to tax them seriously interfered with normal business adjustments. Revenue Act of 1934, Sec. 112.

Section 1031(a)(1) generally provides 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.

In arranging the like-kind exchange, Section 1.1031(k)-1(g)(4) allows taxpayers to use a qualified intermediary to facilitate a like-kind exchange. A taxpayer's transfer of relinquished property to a qualified intermediary and subsequent receipt of like-kind replacement property from the qualified intermediary is treated as an exchange with the qualified intermediary.

Section 1031(f) was subsequently enacted to accord nonrecognition treatment only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment. 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 would not be accorded nonrecognition treatment. See H.R. REP. NO. 101-247, at 1341 (1989), reprinted in 1989 U.S.C.C.A.N. 1906, 2811.

Section 1031(f)(1) sets forth special rules for exchanges between related persons. Section 1031(f)(1) provides that if (1) a taxpayer exchanges property with a related person, (2) nonrecognition treatment applies to the taxpayer in accordance with Section 1031 (without regard to Section 1031(f)) with respect to the exchange, and (3) within two years of the date of the last transfer, 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 as of the date of the disposition of the property received in the exchange.

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of Section 1031(f)(1). These include any disposition (1) after the earlier of the death of the taxpayer or the death of the related person, (2) in a compulsory or involuntary conversion (within the meaning of Section 1033) if the exchange occurred before the threat or imminence of such conversion, or (3) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.
Section 1031(f)(4) provides that Section 1031 shall not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). Thus, if a transaction is set up to avoid the restrictions of Section 1031(f), Section 1031(f)(4) operates to prevent nonrecognition of the gain or loss in the exchange.

Both the Ways and Means Committee Report and the Senate Finance Committee Print describe the policy concern that led to the enactment of Section 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 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.

Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. H.R. REP. NO. 101-247, at 1340-41 (1989), reprinted in 1989 U.S.C.C.A.N. 1906, 2810-11.
The Parking Transaction under Rev. Proc. 2000-37.

Rev. Proc. 2000-37 sets forth a safe harbor for acquiring replacement property under a QEAA, sometimes referred to as a "parking" transaction, to facilitate reverse like-kind exchanges. As provided in this safe harbor, the Service will not challenge either (1) the qualification of property as either replacement or relinquished property (as defined in Section 1.1031(k)-1(a)), or (2) the treatment of the exchange accommodation titleholder as the beneficial owner of such property for Federal income tax purposes, if the property is held in a QEAA as defined in section 4.02 of Rev. Proc. 2000-37.

APPLICATION AND ANALYSIS

In the present case, Related Party's disposal of Relinquished Property # 1 and Relinquished Property # 2 within two years of their acquisition will not trigger taxable gains pursuant to Section 1031(f)(1). Taxpayer and Related Party did not exchange properties either directly or through QI. Taxpayer transferred Relinquished Property # 1 and Relinquished Property # 2 to Related Party through QI, who also purchased Replacement Property # 1 and Replacement Property # 2 from unrelated parties for Taxpayer. Taxpayer's transfer of Relinquished Property # 1 and Relinquished Property # 2 to QI and subsequent receipt of like-kind Replacement Property # 1 and Replacement Property # 2 from QI is treated as an exchange with QI, who is not related to Taxpayer. Treas. Reg. Section 1.1031(k)-1(g)(4).

In addition, Section 1031(f)(4) will not apply to prevent nonrecognition of the gain or loss in the exchange. Taxpayer did not transfer Relinquished Property # 1 and Relinquished Property # 2 to Related Party as part of a transaction or series of transactions structured to avoid the purposes of Section 1031(f)(1). The related parties in this case did not exchange high basis properties for low basis properties in anticipation of the sale of the low basis properties. Only Taxpayer held properties before the exchanges and continued its investments after the exchange. Related Party did not hold

properties before the exchange and purchased Relinquished Property # 1 and Relinquished Property # 2 for cash. Accordingly, Related Party's proposed disposal of Relinquished Property # 1 and Relinquished Property # 2 within two years of the acquisitions will not result in a "cashing out" of any investments or shifting of bases between Taxpayer and Related Party.

RULING

Under the given facts and representations, Section 1031(f) will not apply to trigger recognition of any gain realized when (1) Taxpayer purchases Replacement Property # 1 and Replacement Property # 2 from unrelated parties via EAT or QI, (2) Taxpayer sells Relinquished Property # 1 and Relinquished Property # 2 to Related Party for cash consideration received by QI, and (3) Related Party disposes of Relinquished Property # 1 and Relinquished Property # 2 within two years of the acquisitions.

DISCLAIMERS

Except as provided above, no opinion is expressed as to the Federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of Federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, nor effects resulting from, the transaction that are not specifically covered by the above ruling.

This ruling assumes that (1) EAT is eligible to serve as exchange accommodation titleholder within the meaning of Rev. Proc. 2000-37, (2) QI is eligible to serve as qualified intermediary in this transaction within the meaning of Section 1.1031(k)-1(g)(4), (3) Taxpayer and Related Party are related persons within the meaning of Section 1031(f)(3), (4) the transactions satisfy the requirements for deferred exchanges set forth in Section 1.1031(k)-1, and (5) the first transaction satisfies the safe harbor for reverse exchanges set forth in Rev. Proc. 2000-37. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination. No opinion is expressed as to whether the accommodators used in this transaction are disqualified persons as defined in Section 1.1031(k)-1(k), as that would constitute essentially a factual determination.

This ruling is directed only to Taxpayer. Section 6110 (k)(3) provides that it may not be cited as precedent. Pursuant to the Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representatives.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax and Accounting)

PRIVATE LETTER RULING 200712013

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: March 23, 2007
November 20, 2006

Section 1031 — Exchange of Property Held for Productive Use or Investment

Legend:

Taxpayer = ***
Taxpayer's Address = ***
Taxpayer's ID = ***
Related Party = ***
Limited Liability Co. = ***
$A = ***
$B = ***
D Corp. = ***
E Corp. = ***
F Corp. = ***
Relinquished Property = ***
Replacement Property = ***
Date 1 = ***
Date 2 = ***
Date 3 = ***
Date 4 = ***

Dear ***:

This letter responds to your ruling request submitted on behalf of Taxpayer by letter dated May 22, 2006 as to whether nonrecognition treatment under Section 1031(a) of the Internal Revenue Code will apply to its transfer of real property in a multi-party exchange involving a related party and a qualified intermediary.

STATEMENT OF FACTS

We rely on the facts and conditions set forth in Taxpayer's submissions dated May 22, 2006.

Taxpayer and Related Party are related persons within the meaning of Section 1031(f)(3). Taxpayer acquired Relinquished Property on Date 1 and held it as rental property. In Taxpayer's possession, Relinquished Property's fair market value substantially increased.

Related Party wished to acquire Relinquished Property from Taxpayer, and Taxpayer wished to transfer Relinquished Property to Related Party through a like-kind exchange pursuant to Section 1031. However, because Related Party did not own like-kind assets that Taxpayer wished to acquire, Taxpayer entered into an agreement with an unrelated third party to acquire Replacement Property. Replacement property is like-kind to Relinquished Property within the meaning of Section 1031(a) and Section 1.1031(a)-1(b). Replacement Property's fair market value was substantially higher than Relinquished Property's fair market value. The unrelated third party required the closing of the sale of Replacement Property to occur before Taxpayer transferred Relinquished Property to Related Party, and accordingly, Taxpayer structured the transaction as a "reverse" like-kind exchange under the provisions of Rev. Proc. 2000-37, 2002-2 C.B. 308, modified by Rev. Proc. 2004-51, 2004-2 C.B. 294.

On Date 2, Taxpayer and E Corp. entered into a qualified exchange accommodation arrangement described in Rev. Proc. 2000-37. E Corp. is a domestic single-owner limited liability company and wholly owned by D Corp. E Corp. is disregarded as a separate taxpayer pursuant to Section 301.7701-3(b)(1)(ii) and has never made nor intends to make an election under Section 301.7701-3(c)(1) to be taxed as an association. D Corp. and E Corp. are unrelated to Taxpayer and Related Party. In this reverse like-kind exchange, E Corp. functioned as an exchange accommodation titleholder ("EAT").
In addition, on the same day, Taxpayer loaned to E Corp. $A, which is equal to the purchase price of Replacement Property, and D Corp. granted Taxpayer a security interest in 100-percent of the membership interest in E Corp. as collateral for Taxpayer's loan to E Corp. E Corp. purchased the Replacement Property for $A on Date 3.
On Date 4, Taxpayer entered into an agreement with Related Party to transfer Relinquished Property to Related Party's wholly owned subsidiary, Limited Liability Co. Concurrently, Taxpayer and F Corp., which is an affiliate of D Corp., entered into an agreement to assign Taxpayer's right to receive Relinquished Property sales proceeds, $B, to F Corp. F Corp. is a qualified intermediary ("QI") described in Section 1.1031(k)-1(g)(4), and not a "disqualified person" with respect to Taxpayer within the meaning of Section 1.1031(k)-1(k). Pursuant to the agreements, Taxpayer transferred Relinquished Property to Limited Liability Co., and Limited Liability Co. paid $B to F Corp.
To complete the exchange, Taxpayer instructed F Corp. to acquire Replacement Property. Accordingly, F Corp. purchased 100-percent of the membership interest in E Corp. from D Corp., subject to E Corp.'s obligation under the loan, for $B. At F Corp.'s direction, D Corp. transferred the E Corp.'s membership interest to Taxpayer and also transferred $B to Taxpayer to pay down the loan. Because E is a disregarded entity for federal tax purposes, a transfer of all the interest in E Corp. is treated as a transfer of the assets of E Corp. As a result, the outstanding balance of the loan was cancelled because Taxpayer in effect became both the debtor and the creditor with respect to such balance.

After the above-transactions, Taxpayer held Replacement Property and Related Party held Relinquished Property. Related Party intends to dispose Relinquished Property within two years of its receipt.

LAW AND ANALYSIS

Applicable Requirements for Deferral under Section 1031

Section 1031 was initially promulgated to avoid taxing gains that were mere "paper profits," *i.e.*, the taxpayer had realized nothing tangible and to tax them seriously interfered with normal business adjustments. Revenue Act of 1934, Sec. 112.

Section 1031(a)(1) generally provides 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.

In arranging the like-kind exchange, Section 1.1031(k)-1(g)(4) allows taxpayers to use a QI to facilitate a like-kind exchange. A taxpayer's transfer of relinquished property to a QI and subsequent receipt of like-kind replacement property from the QI is treated as an exchange with the QI.

Section 1031(f) was subsequently enacted to accord nonrecognition treatment only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment. 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 would not be accorded nonrecognition treatment. *See* H.R. REP. NO. 101- 247, at 1341 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2811.

Section 1031(f)(1) sets forth special rules for exchanges between related persons. Section 1031(f)(1) provides that if (1) a taxpayer exchanges property with a related person, (2) nonrecognition treatment is offered to the taxpayer in accordance with Section 1031 with respect to the exchange, and (3) within two years of the date of the last transfer 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 as of the date of the disposition of the property received in the exchange.

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of Section 1031(f)(1). These include any disposition (1) after the earlier of the death of the taxpayer or the death of the related person, (2) in a compulsory or involuntary conversion (within the meaning of Section 1033) if the exchange occurred before the threat or imminence of such conversion, or (3) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

Section 1031(f)(4) provides that Section 1031 shall not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). Thus, if a transaction is set up to avoid the restrictions of Section 1031(f), Section 1031(f)(4) operates to prevent nonrecognition of the gain or loss in the exchange.

Both the Ways and Means Committee Report and the Senate Finance Committee Print describe the policy concern that led to enactment of Section 1031(f)(4):

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 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.

Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. H.R. REP. NO. 101-247, at 1340-41 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2810-11.

The Parking Transaction under Rev. Proc. 2000-37

Rev. Proc. 2000-37 sets forth a safe harbor for acquiring replacement property under a qualified exchange accommodation arrangement ("QEAA"), sometimes referred to as a "parking" transaction, to facilitate reverse like-kind exchanges. As provided in this safe harbor, the Service will not challenge either (1) the qualification of property as either replacement or relinquished property (as defined in Section 1.1031(k)-1(a)), or (2) the treatment of the EAT as the beneficial owner of such property for Federal income tax purposes, if the property is held in a QEAA as defined in section 4.02 of Rev. Proc. 2000-37.

APPLICATION AND ANALYSIS

Taxpayer represents that the exchange satisfies the requirements for deferred exchanges set forth in Section 1.1031(k)-1 and the safe harbor for reverse exchanges set forth in Rev. Proc. 2000-37. Accordingly, the only issue in this case is whether nonrecognition treatment under Section 1031 would apply to a transaction where (1) Taxpayer purchases like-kind Replacement Property from an unrelated third party via EAT, (2) Taxpayer sells Relinquished Property to Related Party for cash consideration received by a QI, and (3) Related Party disposes Relinquished Property within two years of the acquisition.

Related Party's disposal of Relinquished Property within two years of the acquisition will not trigger taxable gains pursuant to Section 1031(f)(1). In the instant case, Taxpayer and Related Party did not engage in a like-kind exchange. Taxpayer transferred Relinquished Property to Related Party through a QI, who also purchased Replacement Property from an unrelated third person for Taxpayer. Taxpayer's transfer of Relinquished Property to the QI and subsequent receipt of like-kind Replacement Property from the QI is treated as an exchange with the QI, who is not related to Taxpayer. Treas. Reg. Section 1.1031(k)-1(g)(4).

In addition, Section 1031(f)(4) will not apply to prevent nonrecognition of the gain or loss in the exchange. Taxpayer did not transfer Relinquished Property to Related Party as part of a transaction or series of transactions, structured to avoid the purposes of Section 1031(f)(1). The related parties in this case did not exchange high basis property for low basis property in anticipation of the sale of the low basis property. Only Taxpayer held property before the reverse like-kind exchange and continued to hold like-kind property after the exchange. Related Party did not hold property before the exchange. Accordingly, Related Party's proposed disposal of Relinquished Property within two years of the acquisition will not result in a "cashing out" of an investment or shifting of basis between Taxpayer and Related Party.

RULING

Under the given facts and representations, Section 1031(f) will not apply to trigger recognition of any gain realized when (1) Taxpayer purchases like-kind Replacement Property from an unrelated third party via EAT, (2) Taxpayer sells Relinquished Property to Related Party for cash consideration received by a QI, and (3) Related Party disposes Relinquished Property within two years of the acquisition.

DISCLAIMERS

Except as provided above, no opinion is expressed as to the Federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of Federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, nor effects resulting from, the transaction that are not specifically covered by the above ruling.

This ruling assumes that (1) E Corp. is eligible to serve as EAT within the meaning of Rev. Proc. 2000-37, (2) F Corp. is eligible to serve as QI in this transaction within the meaning of Section 1.1031(k)-1(g)(4), (3) Taxpayer and Related Party are related persons within the meaning of Section 1031(f)(3), and (4) the transaction satisfies the requirements for deferred exchanges set forth in Section 1.1031(k)-1 and the safe harbor for reverse exchanges set forth in Rev. Proc. 2000-37. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination. No opinion is expressed as to whether the accommodators used in this transaction are disqualified persons as defined in Section 1.1031(k)-1(k), as that would constitute essentially a factual determination.

This ruling is directed only to Taxpayer. Section 6110 (k)(3) provides that it may not be cited as precedent. Pursuant to the Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representatives.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax and Accounting)

PRIVATE LETTER RULING 200709036

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: March 2, 2007
November 28, 2006

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND

Taxpayer =
State A =
Parent REIT =
State B =
Date C =
Operating Partnership =
Property D LLC =
Property D =

Dear ***:

This responds to your request for a private letter ruling dated July 19, 2006, regarding Section 1031 of the Internal Revenue Code.

FACTS

Taxpayer is a State A limited liability company (LLC) that is taxed as a partnership. Taxpayer is an affiliate of Parent REIT, a publicly held real estate investment trust (REIT) organized in State B that elected to be taxed as a REIT beginning with its taxable year ended on Date C.

Parent REIT is the sole general partner and 90 percent owner of Operating Partnership, a State A limited partnership that is classified as a partnership for federal income tax purposes. Operating Partnership owns a 99 percent interest in Taxpayer and is the managing member. Operating Partnership also is sole owner of various entities that have each filed an election under Section 856(l)(1) to be treated as a taxable REIT subsidiary of Taxpayer.

Taxpayer owns multiple parcels of real property through separate LLC's and partnerships. Taxpayer owns all of Property D LLC, a disregarded entity that owns Property D, an office and retail property. Taxpayer has owned and held Property D for more than two years in its business of leasing space to tenants.

Taxpayer proposes the following transaction:

1) Taxpayer will agree to transfer all its membership interest in Property D LLC to a taxable REIT subsidiary (Buyer TRS) for an amount of cash equal to its fair market value (Sale Agreement).

2) Taxpayer will enter into an agreement with an unrelated party to act as a qualified intermediary (QI) (as defined in Section 1.1031(k)-1(g)(4) of the Income Tax Regulations) in the Taxpayer's exchange. The QI will not be a "disqualified person" with respect to Taxpayer within the meaning of Section 1.1031(k)-1(k).

3) Taxpayer will assign to QI its rights to receive all proceeds payable by Buyer TRS in the Sales Agreement.

4) Buyer TRS will pay the price stated in the Sale Agreement to QI and Taxpayer will convey its interest in Property D LLC to Buyer TRS.

5) Taxpayer will identify a limited number of replacement properties to QI within 45 days after the transfer of its interest in Property D LLC to Buyer TRS in compliance with Section 1.1031(k)-1(b) and (c).

6) Taxpayer will direct QI to acquire and transfer to Taxpayer one or more of the designated replacement properties within 180 days after Taxpayer's transfer of its interest in Property D LLC.

Buyer TRS anticipates selling some or all of the property it acquired from Taxpayer within two years from the date of its acquisition by Buyer TRS. Taxpayer and Buyer TRS are related within the meaning of Section 1031(f)(3).

STATEMENT OF LAW

Section 1031(a)(1) generally provides 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) sets forth special rules for exchanges between related persons. 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 in accordance with Section 1031 with respect to the exchange; and

(C) 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 Sectino 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 received in the exchange (the second disposition).

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

ANALYSIS

In the present case, Section 1031(f)(1) is not applicable to currently tax Taxpayer's disposition of Property D because Taxpayer is exchanging property with a QI that is not a related person. However, Section 1031(f)(4) provides that Section 1031 shall not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). Thus, Section 1031 will not apply if Taxpayer's exchange is structured to avoid the "purposes" of Section 1031(f). Both the Ways and Means Committee Report and the Senate Finance Committee Print describe the policy concern that led to enactment of Section 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 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, 101st Cong. 1st Sess. 1340 (1989); S. Print No. 56, at 151.

The Committee Reports also included the following example of when Section 1031(f)(4) applies:

If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. H.R. Rep. No. 247, at 1341; S. Print No. 56, at 152.

In Rev. Rul. 2002-83, the Service discussed and applied Section 1031(f)(4) to the following facts:

Individual A owns real property (Property 1) with a fair market value of $150x and an adjusted basis of $50x. Individual B owns real property (Property 2) with a fair market value of $150x and an adjusted basis of $150x. Both Property 1 and Property 2 are held for investment within the meaning of Section 1031(a). A and B are related persons within the meaning of Â§ 267(b). C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B. Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for $150x. On January 13, 2003, QI acquires Property 2 from B, pays B the $150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

In analyzing these facts under Section 1031(f)(4), the Service quoted the legislative history cited above for the proposition that Section 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. In such case, the original exchange should not be accorded nonrecognition treatment. Under the facts in the revenue ruling, A and B were attempting to sell Property 1 to an unrelated party while using the substituted basis rule of Section 1031(d) to reduce the gain on such sale from $100x to $0. This allowed the parties to "cash out" of their investment in Property 1 without the recognition of gain. The Service concluded that the transaction was structured to avoid the purposes of Section 1031(f) and, therefore, A had gain of $100x on its transfer of Property 1.

In the present case, Taxpayer and Buyer TRS are not exchanging properties either directly or through the QI. Buyer TRS did not own, prior to the exchange, any property that Taxpayer will acquire in the exchange. Rather, prior to the exchange, Taxpayer owns Property D and Buyer TRS, the related person, will acquire Property D by purchasing it for a fair market value price from the QI. Thus, because there is no transaction, or series of transactions, structured to avoid the purposes of Section 1031(f), Section 1031(f)(4) is not applicable. In addition, because Section 1031(f)(1) and Section 1031(f)(4) are not applicable, the restriction contained in Section 1031(f)(1)(C) on disposition of the relinquished property or the replacement property within two years of acquisition does not apply.

RULING

Based on the facts and representations submitted by Taxpayer, we rule that Section 1031(f) will not apply to trigger recognition of any gain realized when Taxpayer (i) transfers the relinquished property to Buyer TRS, a related person, for cash consideration received by the QI, (ii) acquires like-kind replacement property from an unrelated person through the QI, and (iii) Buyer TRS disposes of some or all of Taxpayer's relinquished property within two years of the acquisition.

DISCLAIMERS

These rulings relate only to the application of Section 1031(f) to the exchanges described above. No opinion is expressed regarding whether the other requirements of Section 1031 have been satisfied. In addition, no opinion is expressed regarding whether Parent REIT qualifies as a REIT for federal income tax purposes. Finally, except as specifically provided above, no opinion is expressed as to the federal tax treatment of the transaction under

any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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. 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. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under Â§ 6110. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

This ruling is directed only to Taxpayer. Section 6110 (k)(3) provides that it may not be cited as precedent. Pursuant to a Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representative.

Sincerely,

Michael J. Montemurrro
Chief, Branch 4
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200706001

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: February 9, 2007
October 31, 2006

Section 1031 — Exchange of Property Held for Productive Use or Investment

Legend:

Taxpayer =
Taxpayer's Father =
Taxpayer's Mother =
State =
Trust =
Date =

Dear ***:

This responds to your letter, dated April 24, 2006, requesting a private letter ruling regarding whether the exchange by Taxpayer with the Trust and Taxpayer's three siblings (Siblings) of her undivided twenty-five percent (25%) interest in Parcel # 1 for a hundred percent (100%) interest in Parcel # 3, will constitute a like-kind exchange under Section 1031 of the Internal Revenue Code (the Code)?

Facts

Taxpayer's father, during his lifetime, acquired certain timberlands in State, which he held for income producing and investment purposes. Among the interests were parcels that are subject to this ruling request: Parcel # 1, Parcel # 2, and Parcel # 3.

After Taxpayer's Father's death, Parcel # 1 was transferred to Taxpayer's Mother, and Parcels # 2 and # 3 were transferred to the Trust. Subsequent to the receipt of Parcel # 1, Taxpayer's Mother transferred Parcel # 1, as a gift, to Taxpayer and her Siblings in equal undivided interests as tenants-in-common. The Trust held Parcel's # 2 and # 3 for the benefit of Taxpayer's Mother during her lifetime. The Taxpayer and her Siblings are equal remainder beneficiaries of the Trust's assets.

The trustees of the Trust and the Siblings decided to sell all of their land holdings including Parcels # 1, # 2, and # 3. Taxpayer did not want to divest herself in ownership of real estate, so to accommodate the parties' desires, and to increase the marketability of the parcels, the parties agreed that Taxpayer would exchange her undivided twenty-five percent (25%) interest in Parcel # 1 for a one hundred percent (100%) unencumbered fee simple interest in Parcel # 3. The parties agreed that the fair market value of taxpayer's twenty-five percent (25%) interest in Parcel # 1 was equal to the fair market value of Parcel # 3.

Following the exchange on Date, the Trust and Siblings sold Parcels # 1 and # 2 to an unrelated third party.

Law and Analysis

Section 1031(a)(1) of the Code provides 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 of the Code also provides that replacement property must be identified within 45 days of relinquished property and that the receipt of replacement property for relinquished property must occur within 180 days of the sale of relinquished property.

Rev. Rul. 73-476, 1973-2 C.B. 300 provides that exchanges of undivided interests in multiple parcels of real estate for 100 percent ownership of one or more parcels of the same real estate qualify as valid like-kind exchanges.

Section 1031(f)(1) of the Code generally provides that if (A) a taxpayer exchanges property with a related person, (B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange and (C) before the date 2 years after the date of the last transfer which was part of such exchange-(i) the related person disposes of such property, or (ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer, there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which such subsequent disposition occurs.

Section 1031(f)(2)(C) of the Code provides that there shall not be taken into account any disposition "with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of [f]ederal income tax." The legislative history of Section 1031(f)(2)(C) identifies several situations intended to qualify under this provision. It lists, among others, that the non-tax avoidance exception applies to transactions that do not involve the shifting of basis between properties. H.R. CONF. REP. NO. 101-386, at 614 (1989). The purpose of the exception is to prevent related parties from shifting basis from a low basis asset to a high basis asset in anticipation of the sale of the low basis asset to reduce gain recognition on the disposition of the low basis asset.

In the instant case, Taxpayer exchanged an undivided interest in Parcel # 1 for a fee simple interest in Parcel # 3. Pursuant to Rev. Rul. 73-476, an exchange of an undivided interest in real estate for a fee interest in real estate constitutes an exchange of like kind properties. In addition, since the exchange of Taxpayer's undivided interest in Parcel # 1 for a fee simple interest in Parcel # 3 occurred simultaneously, the exchange meets the 180 day requirement provided in Section 1031(3).

Further, neither the exchange nor the subsequent disposition of Parcel # 1 is a disposition that causes recognition of gain to Taxpayer pursuant to the income recognition rule of Section 1031(f) for exchanges between related persons. The legislative history of Â§ 1031(f)(2)(C) states that dispositions that do not involve the shifting of basis between properties are not taken into account under Section 1031(f)(1) (c). Taxpayer has represented that that the respective per acre basis in Parcels # 1 and # 3 were equivalent as a result of the step-up in basis which occurred when Taxpayer's Father died owning the parcels. Accordingly, under 1031(f)(2)(c) this disposition does not involve basis shifting and therefore will not be taken into account under Section 1031(f)(1)(c).

Conclusion

The exchange by Taxpayer with the Trust and Siblings of her undivided twenty-five percent (25%) interest in Parcel # 1 for a hundred percent (100%) interest in Parcel # 3, will constitute a like-kind exchange under Section 1031 of the Code. In addition, the Trust's subsequent sale of its interest in Parcel # 1 was not a disposition that caused recognition of any gain to Taxpayer, pursuant to 1031(f), because the avoidance of Federal income tax was not one of the principal purposes of the exchange or subsequent disposition of Parcel # 1.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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.

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.

Sincerely yours,

George F. Wright
Senior Technician Reviewer, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200616005

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: April 21, 2006
December 22, 2006

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

CC:ITA:B04
PLR-131347-05
Trust =
S Corp =
Buyer =
A =

Dear ***:

This responds to your request for a private letter ruling dated May 6, 2005, regarding Section 1031 of the Internal Revenue Code.

STATEMENT OF FACTS:

Trust and S Corp are related persons within the meaning of Section 1031(f)(3). Trust owns Building 1 and S Corp owns Building 2. Trust has transferred Building 1, including land and improvements, the tangible personal property, leases and other assets associated with Building 1, to Buyer. Trust wants to defer the recognition of the gain on the transfer of Building 1. Therefore, Trust will acquire Building 2, including land and improvements, as one of its identified replacement properties in exchange for Building 1 in a transaction intended to qualify for nonrecognition treatment under Section 1031. S Corp will also engage in an exchange of Building 2 for other like-kind property in a transaction intended to qualify for nonrecognition treatment under Section 1031.

To facilitate their exchanges, Trust and S Corp will enter into exchange agreements with a qualified intermediary ("QI") described in Section 1.1031(k)- 1(g)(4). Pursuant to Trust's exchange agreement, QI will, for purposes of Section 1031 and the regulations thereunder, be treated as the seller of Building 1 to Buyer. Moreover, QI will be treated as acquiring Building 2 from S Corp and transferring it to Trust in exchange for Building 1. Similarly, pursuant to S Corp's exchange agreement, QI will be treated as acquiring property to replace Building 2 ("S Corp's Replacement Property") and transferring it to S Corp in exchange for Building 2. S Corp's Replacement Property is, prior to its transfer to QI, owned by a party that is not related to either Trust or S Corp.

Once all the transactions are completed, Trust will own Building 2, S Corp will own S Corp's Replacement Property, and Buyer will own Building 1. Trust represents that it will not dispose of Building 2 within two (2) years of its receipt as replacement property. S Corp represents that it will not dispose of S Corp's Replacement Property received in exchange for Building 2 within two (2) years of its receipt as replacement property. For purposes of these representations, both taxpayers assert that the principles of Section 1031(f)(2) apply. Trust and S Corp each seek a ruling regarding the application of Section 1031(f) to their respective exchanges.

After Trust acquires Building 2, QI will still hold approximately $A of the proceeds of the sale of Building 1 to Buyer. Trust has designated and intends to acquire additional like-kind properties from unrelated third parties in the transaction that will qualify under Section 1031. In the event that Trust is unable to acquire such like-kind property, these funds will be distributed by QI to Trust. Trust also requests a ruling that if it receives such cash proceeds, they will cause Trust to recognize gain on the transfer of Building 1 but not in excess of the amount of cash distributed outright to Trust from QI.

STATEMENT OF LAW:

Section 1031(a)(1) generally provides 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(b) provides that if an exchange would be within Section 1031(a)(1) but for the fact that cash or other non-like kind property is received in the exchange, gain is recognized but in an amount not in excess of the cash or other non-like kind property received in the exchange.

Section 1031(f) sets forth special rules for exchanges between related persons. 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 in accordance with Section 1031 with respect to the exchange; and (C) 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 received in the exchange (the second disposition).

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of Section 1031(f)(1)(C). These include any disposition (A) after the earlier of the death of the taxpayer or the death of the related person, or (B) in a compulsory or involuntary conversion (within the meaning of Â§ 1033) if the exchange occurred before the threat or imminence of such conversion. The excepted dispositions also include a disposition with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax.

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

In Rev. Rul. 2002-83, 2002-2 C.B. 927, a taxpayer transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party. As part of the transaction, the related party receives cash for the replacement property. The ruling holds that because the taxpayer's use of the qualified intermediary was to avoid the application of Section 1031(f)(1), the taxpayer, under Section 1031(f)(4), was not entitled to nonrecognition treatment under Section 1031.

ANALYSIS:

In the present case, Section 1031(f)(1) is not applicable to currently tax Trust's disposition of Building 1 because Trust is exchanging property with a qualified intermediary, who is not a related party. However, Section 1031(f)(4) provides that Section 1031 shall not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). Thus, Section 1031 will not apply if Trust's exchange is structured to avoid the "purposes" of Section 1031(f). Both the Ways and Means Committee Report and the Senate Finance Committee Print describe the policy concern that led to enactment of this provision:

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 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, 101st Cong. 1st Sess. 1340 (1989); S. Print No. 56, at 151. The Committee Reports also included the following example of when Section 1031(f)(4) applies: If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. H.R. Rep. No. 247, at 1341; S. Print No. 56, at 152.

In Rev. Rul. 2002-83, the Service discussed and applied Section 1031(f)(4) to the following facts:

Individual A owns real property (Property 1) with a fair market value of $150x and an adjusted basis of $50x. Individual B owns real property (Property 2) with a fair market value of $150x and an adjusted basis of $150x. Both Property 1 and Property 2 are held for investment within the meaning of Section 1031(a). A and B are related persons within the meaning of Â§ 267(b). C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B. Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for $150x. On January 13, 2003, QI acquires Property 2 from B, pays B the $150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

In analyzing these facts under Section 1031(f)(4), the Service quoted the legislative history cited above for the proposition that Section 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. In such case, the original exchange should not be accorded nonrecognition treatment. Under the facts in the revenue ruling, A and B were attempting to sell Property 1 to an unrelated party while using the substituted basis rule of Section 1031(d) to reduce the gain on such sale from $100x to $0. This allowed the parties to "cash out" of their investment in Property 1 without the recognition of gain. The Service concluded that the transaction was structured to avoid the purposes of Section 1031(f)(1) and, therefore, A had gain of $100x on its transfer of Property 1.

The legislative history underlying Section 1031(f)(2)(C) provides that any second disposition by exchanging parties will not be taken into account for purposes of Section 1031(f)(1) if it can be established to the satisfaction of the Secretary that neither the initial exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax. In that regard, the Conference Committee Report, which adopted the Senate amendment, noted that the Senate Finance Committee Report provided that "the non-tax avoidance exception generally will apply to ... dispositions in nonrecognition transactions ...." H.R. Rep. No. 386, 101st Cong., 1st Sess. 613 (1989).

In the present case, the only disposition contemplated by the parties after Trust receives Building 2 as replacement property is the acquisition by S Corp of S Corp's Replacement Property in another exchange under Section 1031, a nonrecognition transaction. Thus, because S Corp is structuring its disposition of Building 2 as an exchange for like-kind replacement property so that the gain on the transfer of Building 2 is eligible for nonrecognition treatment under Section 1031(a), Section 1031(f)(4) and Rev. Rul. 2002-83 are not applicable. Trust's exchange and S Corp's exchange are structured as like-kind exchanges qualifying under Section 1031. There is no "cashing out" of either party's investment in real estate. Upon completion of the series of transactions, both related parties will own property that is like-kind to the property they exchanged. Moreover, neither party will have ever been in receipt of cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property. Finally, under Section 1031(b), any receipt of cash by Trust from QI will result in gain to Trust not in excess of the cash received.

CONCLUSION:

Based on the facts and representations submitted by the taxpayer, we rule as follows:

1. Section 1031(f) will not apply to trigger recognition of any gain realized in Trust's exchange of Building 1 for Building 2 or S Corp's exchange of Building 2 for S Corp's Replacement Property, provided that Trust does not dispose of Building 2 within two (2) years of its receipt as replacement property and S Corp does not dispose of S Corp's Replacement Property received in exchange for Building 2 within two (2) years of its receipt as replacement property.

2. If Trust does not acquire replacement property in addition to Building 2 and receives a distribution of $A from QI, receipt of such cash will cause Trust to recognize gain on the Building 1 transaction, but not in excess of the $A distributed to it from QI.

DISCLAIMERS

These rulings relate only to the application of Section 1031(f) to the exchanges described above. No opinion is expressed regarding whether the other requirements of Section 1031 have been satisfied. Further, even if the other requirements of Section 1031 are met, nonrecognition treatment does not apply to the extent of any boot in the form of cash or other nonlike-kind real, personal or intangible property received by Trust and S Corp in the exchanges at issue. See Section 1031(b); and Rev. Rul. 67-255, 1967-2 C.B. 270. Finally, except as specifically provided above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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. 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. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under Section 6110. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Michael J. Montemurro
Branch Chief (Income Tax & Accounting)
This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PRIVATE LETTER RULING 200440002

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: October 1, 2004
June 14, 2004

Section 1031 — Exchange of Property Held for Productive Use or Investment

LEGEND:

CC:ITA:B04 - PLR-101766-04
DO:
TY:
AB Partnership =
CD Partnership =
Buyer =

Dear ***:

This responds to your request for a private letter ruling, dated December 4, 2003, regarding Section 1031 of the Internal Revenue Code.

STATEMENT OF FACTS:

AB Partnership and CD Partnership are related persons within the meaning of Section 1031(f)(3). AB Partnership owns Building 1 and CD Partnership owns Building 2. AB Partnership has agreed to transfer Building 1, including land and improvements, the tangible personal property, leases and other assets associated with Building 1, to Buyer. AB Partnership wants to defer the recognition of the gain on the transfer of Building 1. Therefore, AB Partnership will acquire Building 2, including land and improvements, as one of its identified replacement properties, in exchange for Building 1 in a transaction intended to qualify for nonrecognition treatment under Section 1031. CD Partnership will also engage in an exchange of Building 2 for other like-kind property in a transaction intended to qualify for nonrecognition treatment under Section 1031.

To facilitate their exchanges, AB Partnership and CD Partnership will enter into exchange agreements with a qualified intermediary ("QI") described in Â§ 1.1031(k)-1(g)(4). Pursuant to AB Partnership's exchange agreement, QI will, for purposes of Section 1031 and the regulations thereunder, be treated as the seller of Building 1 to Buyer. Moreover, QI will be treated as acquiring Building 2 from CD Partnership and transferring it to AB Partnership in exchange for Building 1. Similarly, pursuant to CD Partnership's exchange agreement, QI will be treated as acquiring property to replace Building 2 ("CD's Replacement Property") and transferring it to CD Partnership in exchange for Building 2. CD's Replacement Property is, prior to its transfer to QI, owned by a party that is not related to either AB Partnership or CD Partnership.

Once all the transactions are completed, AB Partnership will own Building 2, CD Partnership will own CD's Replacement Property, and Buyer will own Building 1. AB Partnership represents that it will not dispose of Building 2 within two (2) years of its receipt as its replacement property. CD Partnership represents that it will not dispose of CD's Replacement Property received in exchange for Building 2 within two (2) years of its receipt as replacement property. For purposes of these representations, both taxpayers assert that the principles of Section 1031(f)(2) apply. AB Partnership and CD Partnership each seek a ruling regarding the application of Section 1031(f) to their respective exchanges.

STATEMENT OF LAW:

Section 1031(a)(1) generally provides 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) sets forth special rules for exchanges between related persons. 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 in accordance with Section 1031 with respect to the exchange; and (C) 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 received in the exchange (the second disposition).

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of Section 1031(f)(1)(C). These include any disposition (A) after the earlier of the death of the taxpayer or the death of the related person, or (B) in a compulsory or involuntary conversion (within the meaning of Â§ 1033) if the exchange occurred before the threat or imminence of such conversion. The excepted dispositions also include a disposition with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax. The legislative history regarding the non-tax avoidance exception indicates that it would generally apply to (among other types of transactions) dispositions in nonrecognition transactions. See S. Print No. 56, 101st Cong., 1st Sess. 152 (1989).

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

In Rev. Rul. 2002-83, 2002-2 C.B. 927, a taxpayer transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party. As part of the transaction, the related party receives cash for the replacement property. The ruling holds that because the taxpayer's use of the qualified intermediary was to avoid the application of Section 1031(f)(1), the taxpayer, under Section 1031(f)(4), was not entitled to nonrecognition treatment under Section 1031.

ANALYSIS:

In the present case, Section 1031(f)(1) is not applicable to currently tax AB Partnership's disposition of Building 1 because AB Partnership is exchanging property with a qualified intermediary, who is not a related party. However, Section 1031(f)(4) provides that Section 1031 shall not apply to any exchange that is part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f). Thus, Section 1031 will not apply if AB Partnership's exchange is structured to avoid the "purposes" of Section 1031(f).

Both the Ways and Means Committee Report and the Senate Finance Committee Print, describe the policy concern that led to enactment of this provision:

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 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, 101st Cong. 1st Sess. 1340 (1989); S. Print No. 56, at 151. The Committee Reports also included the following example of when Section 1031(f)(4) applies:

If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031.

H.R. Rep. No. 247, at 1341; S. Print No. 56, at 152.

In Rev. Rul. 2002-83, the Service discussed and applied Section 1031(f)(4) to the following facts:

Individual A owns real property (Property 1) with a fair market value of $150x and an adjusted basis of $50x. Individual B owns real property (Property 2) with a fair market value of $150x and an adjusted basis of $150x. Both Property 1 and Property 2 are held for investment within the meaning of Section 1031(a). A and B are related persons within the meaning of Â§ 267(b). C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B. Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for $150x. On January 13, 2003, QI acquires Property 2 from B, pays B the $150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.
In analyzing these facts under Section 1031(f)(4), the Service quoted the legislative history cited above for the proposition that Section 1031(f)(4) is intended to apply to situations in which related parties effectuate like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. In such case, the original exchange should not be accorded nonrecognition treatment. Under the facts in the revenue ruling, A and B were attempting to sell Property 1 to an unrelated party while using the substituted basis rule of Section 1031(d) to reduce the gain on such sale from $100x to $0. This allowed the parties to "cash out" of their investment in Property 1 without the recognition of gain. The Service concluded that the transaction was structured to avoid the purposes of Section 1031(f)(1) and, therefore, A had gain of $100x on its transfer of Property 1.

The legislative history underlying Section 1031(f)(2)(C) provides that any second disposition by exchanging parties will not be taken into account for purposes of Section 1031(f)(1) if it can be established to the satisfaction of the Secretary that neither the initial exchange nor the second disposition had as one of its principal purposes the avoidance of federal income tax. In that regard, the Conference Committee Report, which adopted the Senate amendment, noted that the Senate Finance Committee Report provided that "the non-tax avoidance exception generally will apply to ... dispositions in nonrecognition transactions ...." H.R. Rep. No. 386, 101st Cong., 1st Sess. 613 (1989).

In the present case, the only subsequent disposition contemplated by the parties after AB Partnership receives Building 2 as replacement property is the use of the proceeds from the disposition of Building 2 by CD Partnership to acquire like-kind replacement property in another exchange under Section 1031, a nonrecognition transaction. Thus, because CD Partnership is structuring its disposition of Building 2 as an exchange for like-kind replacement property so that the gain on the transfer of Building 2 is eligible for nonrecognition treatment under Section 1031(a), Section 1031(f)(4) and Rev. Rul. 2002-83 are not applicable. Both AB Partnership's exchange and CD Partnership's exchange are structured as like-kind exchanges qualifying under Section 1031. There is no "cashing out" of either party's investment in real estate. Upon completion of the series of transactions, both related parties will own property that is like-kind to the property they exchanged. Moreover, neither party will have ever been in receipt of cash or other non-like kind property (other than boot received in the exchange) in return for the relinquished property.

RULING:

Under the given facts and representations, Section 1031(f) will not apply to trigger recognition of any gain realized in AB Partnership's exchange of Building 1 for Building 2 or CD Partnership's exchange of Building 2 for CD's Replacement Property.

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel (Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200251008

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: December 20, 2002
September 11, 2002

Section 1031 — Exchange of Property Held for Productive Use or Investment

Legend:

CC:IT&A:4 -- PLR-106793-02
Taxpayer =
CorpW =
LLC-W =
Husband's Trust =
Husband =
Wife's Trust =
Wife =
Minority Member =
Holding Company =
QI =
EAT =
Titleholder =
Unimproved Real Property =
Relinquished Property or RQ =
Replacement Property or RP =
Business =
State A =
State B =
Village =
City =
County =
A-Acres =
$B =
C-Acres =
$D =
Bank =
$E =

Dear***:

This responds to your letter, dated January 29, 2002, requesting a ruling on the proper federal income tax treatment of a proposed like-kind exchange of real property, as supplemented by letters and submissions dated February 22, March 20, May 16, June 3, June 14, and August 9, 2002. Taxpayer requests a ruling under Section 1031 of the Internal Revenue Code that no gain or loss will be recognized upon the conveyance of Relinquished Property (RQ) to Village and the receipt of Replacement Property (RP).

APPLICABLE FACTS:

Taxpayer is an S corporation, organized under the laws of State A, which operates Business on a calendar year basis, using the accrual method of accounting. Business is situated on RQ. Taxpayer owns a fee interest in RQ, with all improvements thereon.

CorpW, an S corporation organized under the laws of State A, currently leases A-Acres situated on Unimproved Real Property located in City and County under a Lease and Development Agreement ("Lease"), as amended, with City. Lease's term is 45 years from the commencement date (which was on or about September 2, 1997), and one 15-year renewal option.

LLC-W, a State A limited liability company, subleases A-Acres from CorpW and all rights, title, interest and obligations under Lease, for the entire term of Lease. LLC-W plans to utilize A-Acres, in part, as the new location for Business that presently exists on RQ. LLC-W is currently developing and constructing the infrastructure required so that Business can be moved to A-Acres.

Taxpayer and CorpW are related parties, each owned half and half by Husband's Trust and Wife's trust, respectively. LLC-W is also related to Taxpayer, owned 45%, 45% and 10%, respectively, by Husband's Trust, Wife's Trust and Minority Member.

Village and Taxpayer entered into an Option Agreement for Sale and Purchase (Sale Agreement) of RQ on December 12, 2001, and December 13, 2001, respectively. Under Sale Agreement, Taxpayers agreed to sell RQ to Village for $B. However, Taxpayer is arranging to have this transaction (the transfer of RQ to Village) structured as a component of a like-kind exchange under Section 1031 of the Code. Taxpayer will structure the exchange

utilizing the qualified exchange accommodation arrangement (the QEAA) safe harbor provided in Rev. Proc. 2000-37, 2000-40 I.R.B. 308, with an exchange accommodation titleholder (EAT) and its wholly owned subsidiary, Titleholder.

Taxpayer will also use the qualified intermediary safe harbor rules of the deferred exchange regulations at Section 1.1031(k)-1(g)(4) of the Income Tax Regulations, by entering into an exchange agreement with a qualified intermediary (QI). EAT and QI are both State A limited liability companies, wholly owned by Holding Company, a State B limited Partnership. Initially, the QEAA will be between Taxpayer and EAT. Later, Taxpayer's rights under the QEAA will be assigned to QI to facilitate transfer of RP from EAT to Taxpayer. The additional entity mentioned above, Titleholder, will be established for this exchange transaction, specifically to take title to RP. Titleholder will be a limited liability company, with EAT as its sole member, and disregarded for federal income tax purposes.

The exchange will occur as follows: LLC-W will sublease C-Acres (which is part of A-Acres), at a market rental rate, for a fixed term of 32 years to Titleholder as part of the QEAA. EAT will cause Titleholder to construct RP improvements on C-Acres. Taxpayer will identify RQ within 45 days of Titleholder entering into the sublease as provided in Rev. Proc. 2000-37, in a manner consistent with Section 1.1031(k)-1(c).

Under the QEAA, Titleholder will enter into a contract with LLC-W (who will act as Construction Manager and contract on behalf of Titleholder with independent subcontractors) to construct RP improvements based on Taxpayer's plans and specifications. In addition, Titleholder will utilize the Bank Construction Loan (described below) to finance the construction of RP improvements by executing a note payable to Taxpayer, thereby obligating itself to pay Taxpayer for draw requests paid to Construction Manager. The cost to construct RP improvements will approximate $B.

The Bank Construction Loan, in the amount of $E, will be funded by Bank, with Taxpayer as maker and primary obligor. LLC-W and CorpW, together with Husband and Wife, will be guarantors of the Bank Construction Loan.

Subsequent to the commencement of the construction, Taxpayer will assign its rights under Sale Agreement of RQ to QI and give notice of such assignment to all parties to such agreement in writing, all as provided in Section 1.1031(k)- 1(g)(4)(v) of the regulations. Taxpayer will then transfer RQ to Village, as provided in the exchange agreement with QI. Taxpayer will retain liability on the underlying full recourse mortgage on RQ of approximately $D by agreement with Bank. RQ will then be transferred by QI to Village free and clear. Village will pay the purchase price for RQ to QI and QI will receive and hold in escrow the proceeds from the sale of RQ. RQ constitutes substantially all of Taxpayer's assets. Village will not assume any liabilities of Taxpayer incident to the purchase.

To complete the exchange, Taxpayer will assign its rights to receive RP under the QEAA to QI. Thereupon, QI will direct that EAT transfer RP directly to Taxpayer. EAT will effect this transfer by transferring all of its ownership interest in Titleholder directly to Taxpayer. Through this series of transactions, QI will purchase RP from EAT using all the proceeds from the sale of RQ. EAT (through Titleholder) will use all of the proceeds from the sale of RQ to pay Construction Manager for construction and services and pay the loan from Taxpayer in full. Taxpayer will use the repayment proceeds to fully pay Bank Construction Loan before EAT transfers Titleholder to Taxpayer.

Because Titleholder is a disregarded entity for federal tax purposes, EAT will be deemed to enter into any contract Titleholder enters into and to perform any activity Titleholder performs. Furthermore, a transfer of all the interest in Titleholder will be treated as a transfer of the assets of Titleholder. Therefore, any reference herein to the transfer of RP properly refers to the transfer of all the interests of EAT in Titleholder to Taxpayer.
None of the accommodators to be used to implement the proposed exchange (QI, EAT, Titleholder) are disqualified persons as defined in Section 1.1031(k)- 1(k). Also, EAT, Titleholder and QI are subject to federal income tax or, if such persons are treated as partnerships or S corporations for federal income tax purposes, more than 90% of its interest or stock are owned by partners or shareholders who are subject to federal income tax. Services to be performed for Taxpayer by EAT, Titleholder and QI, with respect to exchanges of property are intended to facilitate exchanges that qualify for nonrecognition of gain or loss under Section 1031.

No later than five business days after the transfer of a qualified indicia of ownership of exchange property (RP) to EAT, Taxpayer and EAT will enter into a written agreement (setting up the QEAA) providing that EAT is holding RP in order to facilitate an exchange under Section 1031 and Rev Proc. 2000-37, and that Taxpayer and EAT agree to report the acquisition, holding and disposition of the property as provided in that revenue procedure. The QEAA will specify that EAT will be treated as the beneficial owner of the property for all federal income tax purposes and that Taxpayer and EAT will report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the terms of the QEAA.
Pursuant to the QEAA, Taxpayer will exchange RQ for RP. RP will be real property that consists of a 32-year sublease of C-Acres and specifically identified buildings and improvements on C-Acres to be utilized as part of the relocated Business. The QEAA will also provide that Titleholder will enter into a fixed term 32-year sublease with LLC-W and pay rent to LLC-W at a market rate of rent for C-Acres of land, which is a portion of A-Acres. All improvements to be constructed on RP will be with the approval of City, County, and Bank where required.

No later than 180 days after the transfer of the qualified indicia of ownership of RP to Titleholder (wholly owned by EAT), Titleholder will be transferred directly to Taxpayer. If the production of the identified RP is not completed by Titleholder on or before the 180-day period has expired, EAT will be required by the agreement to transfer all of its interest in Titleholder prior to the completion to Taxpayer in order to comply with the requirements of Rev. Proc. 2000-37.

The agreement between Taxpayer and EAT will expressly limit Taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by EAT or Titleholder in a manner consistent with the requirements of Section 1.1031(k)-1(g)(4)(ii) and (g)(6). EAT will hold qualified indicia of ownership of RP, as defined in Rev. Proc. 2000-37, (through Titleholder) and such qualified indicia of ownership will be held by EAT at all times from the date of acquisition by EAT until the property is transferred to Taxpayer. At the time the qualified indicia of ownership of the property is transferred to EAT, it is Taxpayer's bona fide intent that the property held by EAT represent RP in an exchange that is intended to qualify for nonrecognition of gain (in whole or part) or loss under Section 1031.

In addition to entering into the QEAA, Taxpayer will enter into a written agreement, the exchange agreement, with QI. The exchange agreement will require QI to acquire RQ from Taxpayer and transfer RQ to a purchaser, and to acquire RP and transfer RP to Taxpayer. Pursuant to the exchange agreement, and as provided in Section 1.1031(k)-1(g)(4)(iv) and (v), Taxpayer will assign its rights under Sale Agreement (of RQ to Village) to QI, assign its rights under the QEAA to receive RP also to QI, and give proper and timely notice of these assignments to all parties of Sale Agreement and to all parties of the QEAA.

Pursuant to these agreements, assignments and notices, RQ will be transferred, through QI, to Village, and Taxpayer will receive, through QI, complete ownership of RP by the transfer of all ownership interest in Titleholder. The exchange agreement between Taxpayer and QI will also require that Taxpayer will have no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property (in particular the proceeds resulting from the sale of RQ to Village) held by QI except as provided in Section 1.1031(k)-1(g)(6). Furthermore, since Taxpayer will transfer RQ and receive RP simultaneously, the transaction will effectively satisfy the time requirements in Section 1031(a)(3). Also, RP will not remain in QEAA for a period exceeding 180 days.

The entire proposed transaction at issue can be summarized in the following steps: (1) Taxpayer will enter into the QEAA with EAT, and will enter into an exchange agreement with QI as described. (2) LLC-W will sublease RP at a fair market rental, for 32 years, to Titleholder, a disregarded entity wholly owned by EAT, as part of a QEAA as defined in Rev. Proc. 2000-37. (3) Taxpayer will lend to Titleholder the funds which it (Taxpayer) will borrow from Husband's Trust, Wife's Trust and Bank to construct improvements necessary on leased property for relocation of Business. (4) Taxpayer will assign its rights under Sale Agreement of RQ to QI and will give required notices of such assignment to all interested parties. (5) Taxpayer will transfer RQ free and clear through QI to Village, and QI will receive sales proceeds. (6) Taxpayer will assign its position in the QEAA to QI and give required notices of such assignment to all interested parties. (7) QI will use sales proceeds from RQ to pay EAT for all of its interest in Titleholder (which holds all of RP, consisting of leased property and newly constructed improvements to suit Taxpayer's business requirements). (8) EAT will use the proceeds received from QI (the consideration for the transfer of RP (Titleholder)) to pay Construction Manager and to pay the loan from Taxpayer in full (which Taxpayer will, in turn, use to pay the Bank Construction Loan in full). (9) QI will direct EAT to transfer its interest in Titleholder (holding RP) directly to Taxpayer.

APPLICABLE LAW:

General Requirements for Deferral under Section 1031.

Section 1031(a)(1) 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 that is to be held either for productive use in a trade or business or for investment.

In accordance with this provision, for a transaction to have the effect of deferring gain or loss under Section 1031, it must (1) constitute an exchange, (2) the property transferred and the property received must be held for productive use in a trade or business or for investment, and (3) the property exchanged must be of a like kind.

Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property as distinguished from a transfer of property for a money consideration only. See Section 1.1002-1(d) of the regulations. Under the given facts, there will be an exchange in which the taxpayer will receive property for property rather than money for property. The facts also indicate that both the property to be transferred as RQ and the property to be received as RP are properties held or to be held for use in Taxpayer's trade or business.

Section 1.1031(a)-1(b) of the Income Tax Regulations defines like-kind as referring to the nature or character of the property and not to its grade or quality. Section 1.1031(a)-1(c)(2) provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.

In the present case, Taxpayer is exchanging a fee interest in improved real estate for a long-term lease of a tract of land for a period of more than 30 years and improvements. Accordingly, such properties are of like kind for Â§1031 purposes, provided the requirements of Section 1031(a)(3) are satisfied.

Section 1031(a)(3) provides that property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property; or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extension) of the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

In addition, under general tax accounting principles, if money or other property is actually or constructively received by a taxpayer or an agent of a taxpayer before receiving like-kind replacement property, the disposition of the relinquished property will be treated as a sale under Â§1001 of the Code. Because the transaction at issue in the present case has elements of both a deferred exchange and a reverse (or "parking") transaction, further provisions of the deferred exchange regulations at Section 1.1031(k)-1 and Rev. Proc. 2000-37 are applicable for testing whether the transaction qualifies for deferral of gain (or loss) realized under Section 1031.

Applicable Deferred Exchange Regulations.

On April 25, 1991, the Service issued final regulations under Section 1.1031(k)- 1 providing rules for deferred like-kind exchanges under Section 1031(a)(3) of the Code. Section 1.1031(k)-1(a) of the regulations provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and

subsequently receives property to be held for productive use in a trade or business or for investment (the "replacement property"). In the case of a deferred exchange, if the requirements set forth in Â§1031(a)(3) (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property.

Section 1.1031(k)-1(c)(2) of the regulations generally provides that replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer or any other person involved in the exchange other than the taxpayer or a disqualified person. Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements. Replacement property is identified only if it is unambiguously described. Real property is unambiguously described if it is described by a legal description, street address, or distinguishable name. However, Section 1.1031(k)-1(c)(1) provides, in part, that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

Section 1.1031(k)-1(d)(1) of the regulations provides, in part, that the identified replacement property is received before the end of the exchange period if the taxpayer receives the replacement property before the end of the exchange period, and the replacement property received is substantially the same property as identified.

Section 1.1031(k)-1(e)(1) of the regulations provides that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under Section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of Section 1.1031(k)-1(e)(1), the terms "produced" and "production" have the same meanings as provided in Section 263A(g)(1) and the regulations thereunder.

Section 1.1031(k)-1(e)(2) provides that in the case of replacement property that is to be produced, the replacement property must be identified as provided in Section 1.1031(k)-1(c) (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of Section 1.1031(k)-1(c)(3) (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

Section 1.1031(k)-1(e)(3)(i) generally provides that for purposes of Section 1.1031(k)-1(d)(1)(ii) (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified. Section 1.1031(k)-1(e)(3)(iii) further provides that if the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the property, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

Section 1.1031(k)-1(f)(1) generally provides that a transfer of relinquished property in a deferred exchange is not within the provisions of Section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either Â§1031 (b) or (c). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides, in part, that except as provided in Section 1.1031(k)-1(g) (relating to safe harbors), for purposes of Section 1031 of the Code and Â§1.1031(k)-1 of the regulations, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to Section 1.1031(k)-1(k)) is actual or constructive receipt by the taxpayer.

Section 1.1031(k)-1(g)(2) through (g)(5) of the regulations sets forth a variety of safe harbors for use in deferred exchange situations. The use of one of more of these safe harbors in a deferred exchange will shield a taxpayer from actual or constructive receipt of money or other property.

In the present case, Taxpayer will use the qualified intermediary safe harbor as described in Section 1.1031(k)-1(g)(4) of the regulations. Section 1.1031(k)-1(g)(4)(i) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a). In such a transaction, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange and the determination of whether the taxpayer is in actual or onstructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

Section 1.1031(k)-1(g)(4)(ii) states that the qualified intermediary safe harbor applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in Section 1.1031(k)-1(g)(6).

Section 1.1031(k)-1(g)(4)(iii) defines the term "qualified intermediary" as a person, not the taxpayer or a disqualified person (as defined in Section 1.1031(k)-1(k)), who enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(4)(iv)(A) provides that, regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of Section 1.1031(k)-1(g)(4)(iii)(B), an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property. Section 1.1031(k)-1(g)(4)(iv)(B) provides that an intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person. Section 1.1031(k)-1(g)(4)(iv)(C) provides that an intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

Section 1.1031(k)-1(g)(4)(v) provides that solely for purposes of Section 1.1031(k)-1(g)(4)(iii) and (iv), an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

The Parking Transaction under Rev. Proc. 2000-37.

On September 15, 2000, the Service issued Rev. Proc. 2000-37, 2000-40 I.R.B. 308, setting forth a safe harbor for acquiring replacement property under a QEAA sometimes referred to as a "parking" transaction. As provided in this safe harbor, the Service will not challenge either (a) the qualification of the property as either replacement or relinquished property (as defined in Section 1.1031(k)-1(a) of the regulations) or (b) the treatment of the EAT as the beneficial owner if the property is held in the QEAA as defined in section 4.02 of Rev. Proc. 2000-37. As provided in section 4.02 of the revenue procedure, property is held in the QEAA if all of the following requirements are met:

(1) Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its interests or stock are owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred as described in section 4.02(5) of Rev. Proc. 2000-37. For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of beneficial ownership of property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

(2) At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under Section 1031;

(3) No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37 and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;

(4) No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in Section 1.1031(k)-1(c). The taxpayer may properly identify alternative and multiple properties, as described in Section 1.1031(k)-1(c)(4);

(5) No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in Section 1.1031(k)-1(g)(4)) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that relinquished property and replacement property are held in the QEAA does not exceed 180 days.

Pursuant to section 4.03 of Rev. Proc. 2000-37, property will not fail to be treated as held in the QEAA as a result of any one or more of the following legal or contractual arrangements (listed below, in part, as relevant to the given facts), regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

(1) An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in Section 1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under Section 1031;

(2) The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;

(3) The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder; and

(4) The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property.

APPLICATION AND ANALYSIS:

The proposed transaction is a parking transaction between related parties (Taxpayer and LLC-W). The qualified exchange accommodation arrangement safe harbor (the QEAA) provided by Rev. Proc. 2000-37 applies to the proposed transaction. Taxpayer will also use the qualified intermediary safe harbor as set forth in the deferred exchange regulations under Section 1.1031(k)- 1, although the exchange itself is expected to be simultaneous.

In the present case, a qualified indicia of ownership of RP will be held by EAT in compliance with all requirements stated in section 4.02(1) of Rev. Proc. 2000-37. It is and will be Taxpayer's bona fide intent, now and at the time the qualified indicia of ownership of RP is transferred to EAT, that the property held by EAT represent replacement property in an exchange qualifying for nonrecognition of gain (in whole or in part) or loss under Section 1031, consistent with section 4.02(2) of Rev. Proc. 2000-37.

Within five days after the transfer of RP to EAT, Taxpayer will enter into the QEAA with an EAT providing that EAT (through Titleholder) will acquire RP as required by section 4.02(3) of Rev. Proc. 2000-37. Taxpayer represents that EAT will not be a disqualified person as defined by Section 1.1031(k)-1(k) of the Code.

In addition, Taxpayer will enter into an exchange agreement with QI to facilitate transfer of RQ to Village in the exchange transaction as permitted by Section 1.1031(k)-1(g)(4) of the regulations. Under this provision, a qualified intermediary is not considered the agent of the taxpayer for purposes of Section 1031(a). Thus, Taxpayer's transfer of relinquished property through a qualified intermediary and the subsequent receipt or deemed receipt of like-kind replacement property through a qualified intermediary is treated as an exchange.

All timing requirements necessary for property to be held in the QEAA, relating to notice and transfer of qualified indicia of ownership of the property to EAT, will be satisfied. Within 45 days after the transfer of RP to EAT, Taxpayer will identify RQ as required by section 4.02(4) of Rev. Proc. 2000-37.

Also, as required by section 4.02(5) of Rev. Proc. 2000-37, no later than 180 days after the transfer of qualified indicia of ownership of RP to EAT, RP will be transferred to Taxpayer. Consistent with section 4.02(6) of Rev. Proc. 2000-37, RQ will not be held by EAT in a QEAA and the total time that EAT will hold RP will not exceed 180 days. Moreover, RP will be received by Taxpayer simultaneously with its transfer of RQ through QI to Village. Therefore, Taxpayer will receive RP before the earlier of: (1) 180 days after the date on which the taxpayer transfers RQ in the exchange, (2) the due date (determined with regard to extension) for Taxpayer's tax return for the taxable year in which the transfer of RQ occurs, or (3) 180 days after the date on which RP is transferred to EAT under the QEAA.

As permitted by section 4.02(1) of Rev. Proc. 2000-37, the qualified indicia of ownership of RP will be held by EAT through Titleholder, another disregarded, single member LLC which it wholly owns. EAT is and will be subject to federal income tax and is not Taxpayer or a disqualified person. LLC-W is subleasing C-acres of the Unimproved Real Property to Titleholder. EAT and Titleholder will construct improvements on such property by one or more contractors hired and supervised by LLC-W. C-Acres (which is subleased from CorpW through LLC-W) together with such improvements, constructed by and for Titleholder, will constitute RP. Once EAT (and Titleholder through LLC-W) completes construction of improvements and the exchange of RP for RQ is completed, Taxpayer will take ownership of Titleholder (the disregarded entity holding title to RP).

Section 1.1031-1(e)(1) of the regulations provides that a transfer of relinquished property in a deferred exchange will not fail to qualify for nonrecognition of gain or loss under Section 1031 merely because RP is not in existence or is being produced at the time the property is identified as replacement property. Section 1.1031(k)-1(e)(1) requires a taxpayer to identify RP by providing a legal description of the underlying land that is subject to sublease and as much detail as is practicable regarding the construction of the improvements at the site. In the present case, however, the question of sufficiency of identification of replacement property does not arise because the exchange will be simultaneous, except to the extent the improvements to C-Acres are incomplete when RP is transferred to Taxpayer.

If the production of the identified RP is not completed by EAT on or before the date required to satisfy the requirements of Rev. Proc. 2000-37, EAT will be required by contract to transfer RP to Taxpayer to satisfy those requirements, prior to completion. If this occurs, the identification requirement will be satisfied because Taxpayer will receive RP simultaneously with its transfer of RQ.

Taxpayer will receive no money or other property directly, indirectly or constructively prior to or during the exchange and will receive no economic benefit of money or property other than that derived from the exchange. The only possible exception will be if other property is transferred to Taxpayer incident to the failure of the contractors to timely complete improvements on RP prior to the transfer of Titleholder to Taxpayer. In that event, Taxpayer will have taxable boot in addition to its like-kind replacement property.

RULING:

Accordingly, based on the documents presented, including the exchange agreement with QI, the qualified exchange accommodation agreement with EAT setting up the QEAA, and all other representations made, Taxpayer's transaction will conform with the requirements of the QI and the QEAA safe harbor rules, so that QI and EAT will not be agents of Taxpayer and Taxpayer will not be in actual or constructive receipt of money or other property before receiving RP. Taxpayer will not recognize any gain or loss upon the conveyance of RQ to Village and the receipt of RP. However, if planned improvements are not completed within the exchange period, gain will be recognized to the extent of any boot received in the exchange.

CAVEATS AND EXCEPTIONS:

Except as specifically provided above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Income Tax Regulations that may be applicable or under any other general principles of federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, nor effects resulting from, the transactions that are not specifically covered by the above ruling. No opinion is expressed as to whether the accommodators used in this transaction are disqualified persons as defined in Section 1.1031(k)-1(k), as that would constitute essentially a factual determination. This ruling assumes that QI and EAT are eligible to serve as accommodators.

This ruling is directed only to the taxpayer(s) who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent.
Pursuant to a Power of Attorney submitted by Taxpayer, a copy of this letter will be sent to Taxpayer's authorized representatives.

Sincerely yours,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel (Income Tax & Accounting)
This document may not be used or cited as precedent.

TECHNICAL ADVICE MEMORANDUM 9748006

Date: August 25, 1997

Control No.: TAM-102519-97
Taxpayer's Name: ***
Taxpayer's Address: ***
Taxpayer's ID No.: ***
Years Involved: ***
Conference Held: ***

LEGEND:

Date 1 = ***
Date 2 = ***
Date 3 = ***
Date 4 = ***
Year 1 = ***
Taxpayer = ***
Related Party = ***
UTP = ***
QI = ***
Property X = ***
Property Y = ***
Property Z = ***
$a = ***
$b = ***
$c = ***
$d = ***
$e = ***
$f = ***
$g = ***

ISSUE:

Whether Taxpayer is entitled to nonrecognition treatment under section 1031(a) of the Code with respect to his transfer of real property in a multi-party exchange involving Taxpayer, a related party (Related Party), an unrelated third party (UTP), and a qualified intermediary (QI)?

FACTS:

Prior to the transaction at issue, Taxpayer held Property X, a 1/3 interest in a parcel of unimproved land, for investment. Taxpayer's basis in Property X was $a. Related Party, Taxpayer's mother, held Property Y, a 2/3 interest in the same parcel of unimproved land as Property X. Property X's fair market value was $e.

UTP wanted to acquire the parcel of unimproved land consisting of Property X and property Y. On Date 1, Taxpayer and Related Party entered into a Sale Agreement for the sale of Property X and Property Y to UTP. On Date 2, Related Party purchased Property Z for $f, which she used as a personal residence.

In early Year 1, after he had entered into the Sale Agreement with UTP, Taxpayer decided that he wanted to do a like-kind exchange for other real estate using the proceeds from the sale of Property X. Taxpayer initially sought to acquire replacement real property from another unrelated third party, but could not complete negotiations for the purchase of the replacement real property he wanted in time for the exchange to qualify under section 1031. On Date 3, after Taxpayer determined that acquisition of this replacement property was unfeasible, he entered into the purchase and Sale Agreement with Related Party to acquire Property Z for $f.

On Date 4, Taxpayer, Related Party, UTP and QI engaged in an exchange transaction which occurred in the following steps: First, Taxpayer assigned and transferred all of his rights, title and interest in Property X and his rights and obligations under the Sale Agreement with UTP to QI. Second, Taxpayer assigned his rights and obligations under the purchase and Sale Agreement to acquire Property Z to QI. Third, in accordance with the Sale Agreement, QI sold Property X to UTP for $e. Fourth, QI paid $e (proceeds from the sale of Property X) to Related Party and Taxpayer paid an additional $b directly to Related Party for property z. Fifth, Related Party transferred property z, via QI, to Taxpayer. Separate from, but concurrent with, the exchange transaction, UTP paid Related Party $g to acquire Property Y.

After the exchange, Taxpayer held Property Z for investment, UTP owned Property X, and Related Party had $f cash. It is assumed that QI is a qualified intermediary as defined in section 1.1031(k)-1(g)(4)(iii) of the Income Tax Regulations. Thus, if the exchange qualifies under section 1031 of the Code, Taxpayer recognizes no gain or loss from the transaction and his new basis in Property Z is $c ($a + $b).

APPLICABLE LAW:

Section 1031(a)(1) of the Internal Revenue 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 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(d) of the Code provides that the basis of property acquired in a like-kind exchange is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange.

Section 1.1031(k)-1(g) of the regulations establishes 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."

Section 1.1031(k)-1(g)(4)(iii) of the regulations defines a qualified intermediary as a person who (A) is not the taxpayer or a disqualified person and (B) enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(b)-2(a) of the regulations provides that in the case of simultaneous transfers of like-kind properties involving qualified intermediaries (as defined in section 1.1031(k)- 1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the transfer and receipt of property by the taxpayer through a qualified intermediary is treated as an exchange.

Section 1031(f)(1) of the Code provides that if a taxpayer exchanges property with a related person, resulting in nonrecognition of gain or loss under this section with respect to the exchange, and if within two years of such exchange the related person or the taxpayer disposes of the property received in the exchange, there is no loss nonrecognition of gain or loss under section 1031 to the taxpayer with respect to such exchange. Any gain or loss recognized by the taxpayer by reason of section 1031(f)(1) is taken into account as of the date such latter disposition occurs.

Section 1031(f)(2) of the Code provides that for purposes of paragraph (f)(1), there shall not be taken into account any disposition (A) after the earlier of the death of the taxpayer or the death of the related person, (B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or (C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

Section 1031(f)(3) of the Code provides that the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or section 707(b)(1).

Section 1031(f)(4) of the Code 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 section 1031(f).

ANALYSIS:

The rationale for permitting taxpayers to defer gain or loss when they exchange like-kind properties is the perception that such recognition is inappropriate for taxpayers remaining invested in the same kind or class of property. No "cashing out" of the investment has occurred. See H. R. Rep. No. 101-247, 101st Cong., 1st Sess. 1340 (1989).

However, prior to the enactment of section 1031(f), a taxpayer could, in effect, "cash out" its investment without recognizing gain by structuring the disposition as a like-kind exchange with a related party. By doing this, the taxpayer could shift high basis from the property the taxpayer wished to retain to low basis property the taxpayer wished to sell. The House Budget Committee Report accompanying the enactment of section 1031(f) recognized that 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. The exchange would then position the parties to avoid or substantially reduce the recognition of gain on the subsequent sale.

Section 1031(f) is thus intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The committee determined 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, 101st Cong. 1st Sess. 1340 (1989)(emphasis added). The committee thus treats the related parties in these transactions as a single taxpayer, and the subsequent disposition of exchange property by one related party as a "cashing out" by the other related party.

In this case, Taxpayer disposed of Property X through a qualified intermediary QI and through the same qualified intermediary acquired Property Z from Related Party. The economic result of this series of transactions is identical to what would have occurred in a direct exchange of Property X for Property Z between Taxpayer and Related Party, followed by a sale of Property X by Related Party to UTP. In both cases and after all steps are concluded, Taxpayer owns Property Z with a basis of $c, Related Party has sale proceeds of $f (but no gain because of Related Party's $f basis in Property Z), and UTP owns Property X. However, due to the application of section 1031(f), Taxpayer would recognize gain of $d in the case of the direct exchange.

Congress enacted section 1031(f)(4) to prevent related parties from circumventing subsection (f)(1) through, among other means, the structuring of transactions to involve unrelated parties. As an example, the committee report states that "if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031." H. R. Rep. No. 101-247 at 1341.

The deferred exchange regulations in section 1.1031(k)-1 provide for the use of a qualified intermediary as one way to effect a like kind exchange. However, a qualified intermediary is not entitled to better treatment than the unrelated party referred to in the House Budget Committee Report. Thus, the mere interposition of a qualified intermediary will not correct a transaction otherwise flawed under section 1031(f)(1).

Taxpayer argues that there was no tax avoidance motive to the exchange because no such motive existed at the time that Taxpayer and Related Party entered into the Sale Agreement with UTP. Taxpayer asserts that the fact that Related Party did not own Property Z at the time that the Sale Agreement was entered into and that there was no commitment or obligation on his part to transfer Property X to Related Party is evidence of the lack of tax avoidance motive in the exchange. However, nothing in the statute or legislative history suggests that the only appropriate time for determining the existence of a tax avoidance motive is the time that the related parties first commit to sell the low basis property (Properties X and Y). Nor does the example in House Budget Committee Report assume (and thereby require for application of section 1031(f)(4)), as Taxpayer argues, that there is a prearranged plan among the related parties and the unrelated third party and a pre-existing commitment or understanding at the inception of the arrangement that the related parties were going to exchange their property interests.

Taxpayer also asserts that the fact that UTP, instead of Related Party, could have acquired Property Z and exchanged this property with Taxpayer for Property X under section 1031 is additional evidence of the lack of Taxpayer's tax avoidance motive.

Taxpayer further argues that the transaction was initially structured as an exchange with unrelated parties and therefore was not structured to avoid the related party rules. Taxpayer initially sought to acquire replacement-real property from another unrelated third party, but was unable to acquire the real property he wanted in time for the exchange to qualify under section 1031. Only after Taxpayer failed to acquire replacement property from an unrelated third party did he enter into the Purchase and Sale Agreement with Related Party to acquire Property Z. Thus, since the transaction was not "structured" to avoid the related party rules, Taxpayer asserts that section 1031(f)(4) does not apply.

Taxpayer has offered no explanation for the use of the qualified intermediary in this transaction. As noted above, the direct exchange of Property X for Property Z, followed by the sale of Property X to UTP would have been in violation of section 1031(f)(1) and would have caused Taxpayer to recognize gain in the amount of $d. It is apparent that Taxpayer and Related Party utilized a qualified intermediary for the sole purpose of avoiding the related party rules of section 1031(f). It is this aspect of the transaction's structure that manifests Taxpayer's intent to avoid application of the related party rules. Moreover, the mere possibility of the existence of alternative schemes (that would qualify under section 1031(a)) to accomplish the same end result does not negate Taxpayer's intention in undertaking the exchange that actually occurred. Thus, Taxpayer's exchange of Property X for Property Z is part of a transaction structured to avoid the purposes of section 1031(f) within the meaning of section 1031(f)(4).

Section 1031(f)(2)(C) provides an exception to the disqualification of a related party exchange for section 1031(a) nonrecognition treatment under section 1031(f)(1). Although this exchange is not a related party exchange because of the use of the qualified intermediary QI, Taxpayer argues that the exchange did not have as one of its principal purposes the avoidance of Federal income tax as provided in section 1031(f)(2)(C) and therefore should qualify for nonrecognition treatment under section 1031(a) despite the application of section 1031(f)(4). However, in this case there is no need to determine whether section 1031(f)(2)(C) is also an exception to section 1031(f)(4), since Taxpayer has not established that the exchange did not have as one of its principal purposes the avoidance of Federal income tax.

Under these facts, Taxpayer has not demonstrated that use of the qualified intermediary QI was not to avoid the purposes of the related party rules of section 1031(f). Accordingly, pursuant to section 1031(f)(4), Taxpayer's exchange of Property X for Property Z with the qualified intermediary QI is not eligible for nonrecognition treatment under section 1031(a).

CONCLUSION:

Taxpayer is not entitled to nonrecognition treatment undersection 1031(a) with respect to his transfer of Property X in a multi-party exchange involving Taxpayer, a related party (Related Party), an unrelated third party (UTP), and a qualified intermediary (QI).

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

SECTION 121 EXCLUSION ON PRIMARY RESIDENCE

Sec. 1.121-1

Exclusion of gain from sale or exchange of a principal residence.

(a) In general. Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

(b) Residence—

(1) In general. Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house orapartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

(2) Principal residence. In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to—

(i) The taxpayer's place of employment;

(ii) The principal place of abode of the taxpayer's family members;

(iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;

(iv) The taxpayer's mailing address for bills and correspondence;

(v) The location of the taxpayer's banks; and

(vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

(3) Vacant land—

(i) In general. The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless--

(A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;

(B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;

(C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and

(D) The requirements of section 121 have otherwise been met with respect to the vacant land.

(ii) Limitations—

(A) Maximum limitation amount. For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), the sale or exchange of the dwelling unit and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of vacant land and the dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and Sec. 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

(B) Sale or exchange of more than one principal residence in 2-year period. If a dwelling unit and vacant land are sold or exchanged in separate transactions that qualify for the section 121 exclusion under this paragraph (b)(3), each of the transactions is disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to the other transactions but is taken into account as a sale or exchange of a principal residence on the date of the transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

(C) Sale or exchange of vacant land before dwelling unit. If the sale or exchange of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. If the taxpayer has reported gain from the sale or

exchange of the vacant land as taxable, after satisfying the requirements of this paragraph (b)(3) the taxpayer may claim the section 121 exclusion with regard to the sale or exchange of the vacant land (for any period for which the period of limitation under section 6511 has not expired) by filing an amended return.

(4) Examples. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. Taxpayer A owns 2 residences, one in New York and one in Florida. From 1999 through 2004, he lives in the New York residence for 7 months and the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is A's principal residence. A would be eligible for the section 121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence.

Example 2. Taxpayer B owns 2 residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, she lives in the Maine residence. During 2003, she lives in the Virginia residence. B's principal residence during 1999, 2000, and 2003 is the Virginia residence. B's principal residence during 2001 and 2002 is the Maine residence. B would be eligible for the 121 exclusion of gain from the sale or exchange of either residence (but not both) during 2003.

Example 3. In 1991 Taxpayer C buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2005 C sells 8 acres of the land and realizes a gain of $110,000. C does not sell the dwelling unit before the due date for filing C's 2005 return, therefore C is not eligible to exclude the $110,000 of gain. In March 2007 C sells the house and remaining 2 acres realizing a gain of $180,000 from the sale of the house. C may exclude the $180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence under paragraph (b)(3) of this section. C may file an amended return for 2005 to claim an exclusion for $70,000 ($250,000-$180,000 gain previously excluded) of the $110,000 gain from the sale of the 8 acres.

Example 4. In 1998 Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999 D buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003 D sells the house and 1 acre and the 29 acres in 2 separate transactions. D sells the house and 1 acre at a loss of $25,000. D realizes $270,000 of gain from the sale of the 29 acres. D may exclude the $245,000 gain from the 2 sales.

(c) Ownership and use requirements—

(1) In general. The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 x 2). The requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange.

(2) Use.

(i) In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

(ii) Determination of use during periods of out-of-residence care. If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sells or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for periods aggregating at least 1 year during the 5-year period preceding the sale or exchange, the taxpayer is treated as using the property as the taxpayer's principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

(3) Ownership—

(i) Trusts. If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.

(ii) Certain single owner entities. If a residence is owned by an eligible entity (within the meaning of Sec. 301.7701-3(a) of this chapter) that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner under Sec. 301.7701-3 of this chapter, the owner will be treated as owning the residence for purposes of satisfying the2-year ownership requirement of section 121, and the sale or exchange by the entity will be treated as if made by the owner.

(4) Examples. The provisions of this paragraph (c) are illustrated by the following examples. The examples assume that Sec. 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Taxpayer A has owned and used his house as his principal residence since 1986. On January 31, 1998, A moves to another state. A rents his house to tenants from that date until April 18, 2000, when he sells it. A is eligible for the section 121 exclusion because he has owned and used the house as his principal residence for at least 2 of the 5 years preceding the sale.

Example 2. Taxpayer B owns and uses a house as her principal residence from 1986 to the end of 1997. On January 4, 1998, B moves to another state and ceases to use the house. B's son moves into the house in March 1999 and uses the residence until it is sold on July 1, 2001. B may not exclude gain from the sale under section 121 because she did not use the property as her principal residence for at least 2 years out of the 5 years preceding the sale.

Example 3. Taxpayer C lives in a townhouse that he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughter's home, C sells his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 1997 until May 25, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995 until February 1, 1998).

Example 4. Taxpayer D, a college professor, purchases and moves into a house on May 1, 1997. He uses the house as his principal residence continuously until September 1, 1998, when he goes abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sells the house. Because his leave is not considered to be a short temporary absence under paragraph (c)(2) of this section, the period of the sabbatical leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121 because he did not use the residence for the requisite period.

Example 5. Taxpayer E purchases a house on February 1, 1998, that he uses as his principal residence. During 1998 and 1999, E leaves his residence for a 2-month summer vacation. E sells the house on March 1, 2000. Although, in the 5-year period preceding the date of sale, the total time E used his residence is less than 2 years (21 months), the section 121 exclusion will apply to gain from the sale of the residence because, under paragraph (c)(2) of this section, the 2-month vacations are short temporary absences and are counted as periods of use in determining whether E used the residence for the requisite period.

(d) Depreciation taken after May 6, 1997—

(1) In general. The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to the property for periods after May 6, 1997. Depreciation adjustments allocable to any portion of the property to which the section 121 exclusion does not apply under paragraph (e) of this section are not taken into account for this purpose.

(2) Example. The provisions of this paragraph (d) are illustrated by the following example:

Example. On July 1, 1999, Taxpayer A moves into a house that he owns and had rented to tenants since July 1, 1997. A took depreciation deductions totaling $14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, A sells the property on August 1, 2001. A's gain realized from the sale is $40,000. A has no other section 1231 or capital gains or losses for 2001. Only $26,000 ($40,000 gain realized--$14,000 depreciation deductions) may be excluded under section 121. Under section 121(d)(6) and paragraph (d)(1) of this section, A must recognize $14,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h).

(e) Property used in part as a principal residence—

(1) Allocation required. Section 121 will not apply to the gain allocable to any portion (separate from the dwelling unit) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under section 121. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, section 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by paragraph (d) of this section.

(2) Dwelling unit. For purposes of this paragraph (e), the term dwelling unit has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

(3) Method of allocation. For purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in section 1250(b)(3)), if applicable.

(4) Examples. The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. Non-residential use of property not within the dwelling unit. (i) Taxpayer A owns a property that consists of a house, a stable and 35 acres. A uses the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. A uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, 1997, A claims depreciation deductions of $9,000 for the non-residential use of the stable. A sells the entire property in 2004, realizing a gain of $24,000. A has no other section 1231 or capital gains or losses for 2004.

(ii) Because the stable and the 28 acres used in the business are separate from the dwelling unit, the allocation rules under this paragraph (e) apply and A must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. A determines that $14,000 of the gain is allocable to the non-residential-use portion of the property and that $10,000 of the gain is allocable to the portion of the property used as his residence. A must recognize the $14,000 of gain allocable to the non-residential-use portion of the property ($9,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and $5,000 of which is adjusted net capital gain). A may exclude $10,000 of the gain from the sale of the property.

Example 2. Non-residential use of property not within the dwelling unit and rental of the entire property.

(i) In 1998 Taxpayer B buys a property that includes a house, a barn, and 2 acres. B uses the house and 2 acres as her principal residence and the barn for an antiques business. In 2002, B moves out of the house and rents it to tenants. B sells the property in 2004, realizing a gain of $21,000. Between 1998 and 2004 B claims depreciation deductions of $4,800 attributable to the antiques business. Between 2002 and 2004 B claims depreciation deductions of $3,000 attributable to the house. B has no other section 1231 or capital gains or losses for 2004.

(ii) Because the portion of the property used in the antiques business is separate from the dwelling unit, the allocation rules under this paragraph (e) apply. B must allocate basis and amount realized between the portion of the property that she used as her principal residence and the portion of the property that she used for non-residential purposes. B determines that $4,000 of the gain is allocable to the non-residential portion of the property and that $17,000 of the gain is allocable to the portion of the property that she used as her principal residence.

(iii) B must recognize the $4,000 of gain allocable to the non-residential portion of the property (all of which is unrecaptured section 1250 gain within the meaning of section 1(h)). In addition, the section 121 exclusion does not apply to the gain allocable to the residential portion of the property to the extent of the depreciation adjustments attributable to the residential portion of the property for periods after May 6, 1997 ($3,000). Therefore, B may exclude $14,000 of the gain from the sale of the property.

Example 3. Non-residential use of a separate dwelling unit.

(i) In 2002 Taxpayer C buys a 3-story townhouse and converts the basement level, which has a separate entrance, into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that leads from the basement to the upper floors. After the conversion, the property constitutes 2 dwelling units within the meaning of paragraph (e)(2) of this section. C uses the first and second floors of the townhouse as his principal residence and rents the basement level to tenants from 2003 to 2007. C claims depreciation deductions of $2,000 for that period with respect to the basement apartment. C sells the entire property in 2007, realizing gain of $18,000. C has no other section 1231 or capital gains or losses for 2007.

(ii) Because the basement apartment and the upper floors of the townhouse are separate dwelling units, C must allocate the gain between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes under paragraph (e) of this section. After allocating the basis and theamount realized between the residential and non-residential portions of the property, C determines that $6,000 of the gain is allocable to the non-residential portion of the property and that $12,000 of the gain is allocable to the portion of the property used as his residence. C must recognize the $6,000 of gain allocable to the non-residential portion of the property ($2,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and $4,000 of which is adjusted net capital gain). C may exclude $12,000 of the gain from the sale of the property.

Example 4. Separate dwelling unit converted to residential use. The facts are the same as in Example 3 except that in 2007 C incorporates the basement of the townhouse into his principal residence by eliminating the kitchen and building a new interior stairway to the upper floors. C uses all 3 floors of the townhouse as his principal residence for 2 full years and sells the townhouse in 2010, realizing a gain of $20,000. Under section 121(d)(6) and paragraph (d) of this section, C must recognize $2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). Because C used the entire 3 floors of the townhouse as his principal residence for 2 of the 5 years preceding the sale of the property, C may exclude the remaining $18,000 of the gain from the sale of the house.

Example 5. Non-residential use within the dwelling unit, property depreciated. Taxpayer D, an attorney, buys a house in 2003. The house constitutes a single dwelling unit but D uses a portion of the house as a law office. D claims depreciation deductions of $2,000 during the period that she owns the house. D sells the house in 2006, realizing a gain of $13,000. D has no other section 1231 or capital gains or losses for 2006. Under section 121(d)(6) and paragraph (d) of this section, D must recognize $2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). D may exclude the remaining $11,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

Example 6. Non-residential use within the dwelling unit, property not depreciated. The facts are the same as in Example 5, except that D is not entitled to claim any depreciation deductions with respect to her business use of the house. D may exclude $13,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

(f) Effective date. This section is applicable for sales and exchanges on or after Decmeber 24, 2002. For rules on electing to apply the provisions of this section retroactively, see Sec. 1.121-4(j).

Sec. 1.121-2
Limitations.

(a) Dollar limitations—

(1) In general. A taxpayer may exclude from gross income up to $250,000 of gain from the sale or exchange of the taxpayer's principal residence. A taxpayer is eligible for only one maximum exclusion per principal residence.

(2) Joint owners. If taxpayers jointly own a principal residence but file separate returns, each taxpayer may exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property, if the requirements of section 121 have otherwise been met.

(3) Special rules for joint returns—

(i) In general. A husband and wife who make a joint return for the year of the sale or exchange of a principal residence may exclude up to $500,000 of gain if--

(A) Either spouse meets the 2-year ownership requirements of Sec. 1.121-1(a) and (c);

(B) Both spouses meet the 2-year use requirements of Sec. 1.121-1(a) and (c); and

(C) Neither spouse excluded gain from a prior sale or exchange of property under section 121 within the last 2 years (as determined under paragraph (b) of this section).

(ii) Other joint returns. For taxpayers filing jointly, if either spouse fails to meet the requirements of paragraph (a)(3)(i) of this section, the maximum limitation amount to be claimed by the couple is the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

(4) Examples. The provisions of this paragraph (a) are illustrated by the following examples. The examples assume that Sec. 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Unmarried Taxpayers A and B own a house as joint owners, each owning a 50 percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years.

The gain realized from the sale is $256,000. A and B are each eligible to exclude $128,000 of gain because the amount of realized gain allocable to each of them from the sale does not exceed each taxpayer's available limitation amount of $250,000.

Example 2. The facts are the same as in Example 1, except that A and B are married taxpayers who file a joint return for the taxable year of the sale. A and B are eligible to exclude the entire amount of realized gain ($256,000) from gross income because the gain realized from the sale does not exceed the limitation amount of $500,000 available to A and B as taxpayers filing a joint return.

Example 3. During 1999, married Taxpayers H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. H and W file a joint return for the year of the sales. The gain realized from the sale of H's residence is $200,000. The gain realized from the sale of W's residence is $300,000. Because the ownership and use requirements are met for each residence by each respective spouse, H and W are each eligible to exclude up to $250,000 of gain from the sale of their individual residences. However, W may not use H's unused exclusion to exclude gain in excess of her limitation amount. Therefore, H and W must recognize $50,000 of the gain realized on the sale of W's residence.

Example 4. Married Taxpayers H and W sell their residence and file a joint return for the year of the sale. W, but not H, satisfies the requirements of section 121. They are eligible to exclude up to $250,000 of the gain from the sale of the residence because that is the sum of each spouse's dollar limitation amount determined on a separate basis as if they had not been married ($0 for H, $250,000 for W).

Example 5. Married Taxpayers H and W have owned and used their principal residence since 1998. On February 16, 2001, H dies. On September 24, 2001, W sells the residence and realizes a gain of $350,000. Pursuant to section 6013(a)(3), W and H's executor make a joint return for 2001. All $350,000 of the gain from the sale of the residence may be excluded.

Example 6. Assume the same facts as Example 5, except that W does not sell the residence until January 31, 2002. Because W's filing status for the taxable year of the sale is single, the special rules for joint returns under paragraph (a)(3) of this section do not apply and W may exclude only $250,000 of the gain.

(b) Application of section 121 to only 1 sale or exchange every 2 years—

(1) In general. Except as otherwise provided in Sec. 1.121-3 (relating to the reduced maximum exclusion), a taxpayer may not exclude from gross income gain from the sale or exchange of a principal residence if, during the 2-year period ending on the date of the sale or exchange, the taxpayer sold or exchanged other property for which gain was excluded under section 121. For purposes of this paragraph (b)(1), any sale or exchange before May 7, 1997, is disregarded.

(2) Example. The following example illustrates the rules of this paragraph (b). The example assumes that Sec. 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property.

The example is as follows:

Example. Taxpayer A owns a townhouse that he uses as his principal residence for 2 full years, 1998 and 1999. A buys a house in 2000 that he owns and uses as his principal residence. A sells the townhouse in 2002 and excludes gain realized on its sale under section 121. A sells the house in 2003. Although A meets the 2-year ownership and use requirements of section 121, A is not eligible to exclude gain from the sale of the house because A excluded gain within the last 2 years under section 121 from the sale of the townhouse.

(c) Effective date. This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see Sec. 1.121-4(j).

Sec. 1.121-3
Reduced maximum exclusion for taxpayers failing tomeet certain requirements.

(a) In general. In lieu of the limitation under section 121(b) and Sec. 1.121-2, a reduced maximum exclusion limitation may be available for a taxpayer who sells or exchanges property used as the taxpayer's principal residence but fails to satisfy the ownership and use requirements described in Sec. 1.121-1(a) and (c) or the 2-year limitation described in Sec. 1.121-2(b).

(b) Primary reason for sale or exchange. In order for a taxpayer to claim a reduced maximum exclusion under section 121(c), the sale or exchange must be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor described in this section applies, a sale or exchange is deemed to be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor described in this section does not apply, a sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the primary reason for the sale or exchange is a change in place of employment (within the meaning of paragraph (c) of this section), health (within the meaning of paragraph (d) of this section), or unforeseen circumstances (within the meaning of paragraph (e) of this section). Whether the requirements of this section are satisfied depends upon all the facts and circumstances. Factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which--

(1) The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;

(2) The suitability of the property as the taxpayer's principal residence materially changes;

(3) The taxpayer's financial ability to maintain the property is materially impaired;

(4) The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;

(5) The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and

(6) The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(c) Sale or exchange by reason of a change in place of employment--

(1) In general. A sale or exchange is by reason of a change in place of employment if, in the case of a qualified individual described in paragraph (f) of this section, the primary reason for the sale or exchange is a change in the location of the individual's employment.

(2) Distance safe harbor. A sale or exchange is deemed to be by reason of a change in place of employment (within the meaning of paragraph (c)(1) of this section) if—

(i) The change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; and

(ii) The qualified individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the qualified individual's new place of employment and the residence sold or exchanged is at least 50 miles.

(3) Employment. For purposes of this paragraph (c), employment includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment.

(4) Examples. The following examples illustrate the rules of this paragraph (c):

Example 1. A is unemployed and owns a townhouse that she has owned and used as her principal residence since 2003. In 2004 A obtains a job that is 54 miles from her townhouse, and she sells the townhouse. Because the distance between A's new place of employment and the townhouse is at least 50 miles, the sale is within the safe harbor of paragraph (c)(2) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. B is an officer in the United States Air Force stationed in Florida. B purchases a house in Florida in 2002. In May 2003 B moves out of his house to take a 3-year assignment in Germany. B sells his house in January 2004. Because B's new place of employment in Germany is at least 50 miles farther from the residence sold than is B's former place of employment in Florida, the sale is within the safe harbor of paragraph (c)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. C is employed by Employer R at R's Philadelphia office. C purchases a house in February 2002 that is 35 miles from R's Philadelphia office. In May 2003 C begins a temporary assignment at R's Wilmington office that is 72 miles from C's house, and moves out of the house. In June 2005 C is assigned to work in R's London office. C sells her house in August 2005 as a result of the assignment to London. The sale of the house is not within the safe harbor of paragraph (c)(2) of this section by reason of the change inplace of employment from Philadelphia to Wilmington because the Wilmington office is not 50 miles farther from C's house than is the Philadelphia office. Furthermore, the sale is not within the safe harbor by reason of the change in place of employment to London because C is not using the house as her principal residence when she moves to London. However, C is entitled to claim a reduced maximum exclusion under
section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in C's place of employment.

Example 4. In July 2003 D, who works as an emergency medicine physician, buys a condominium that is 5 miles from her place of employment and uses it as her principal residence. In February 2004, D obtains a job that is located 51 miles from D's condominium. D may be called in to work unscheduled hours and, when called, must be able to arrive at work quickly. Because of the demands of the new job, D sells her condominium and buys a townhouse that is 4 miles from her new place of employment. Because D's new place of employment is only 46 miles farther from the condominium than is D's former place of employment, the sale is not within the safe harbor of paragraph (c)(2) of this section. However, D is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in D's place of employment.

(d) Sale or exchange by reason of health—

(1) In general. A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual described in paragraph (f) of this section, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of an individual is not a sale or exchange by reason of health.

(2) Physician's recommendation safe harbor. A sale or exchange is deemed to be by reason of health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health (as defined in paragraph (d)(1) of this section).

(3) Examples. The following examples illustrate the rules of this paragraph (d):

Example 1. In 2003 A buys a house that she uses as her principal residence. A is injured in an accident and is unable to care for herself. A sells her house in 2004 and moves in with her daughter so that the daughter can provide the care that A requires as a result of her injury. Because, under the facts and circumstances, the primary reason for the sale of A's house is A's health, A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H's father has a chronic disease. In 2003 H and W purchase a house that they use as their principal residence. In 2004 H and W sell their house in order to move into the house of H's father so that they can provide the care he requires as a result of his disease. Because, under the facts and circumstances, the primary reason for the sale of their house is the health of H's father, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. H and W purchase a house in 2003 that they use as their principal residence. Their son suffers from a chronic illness that requires regular medical care. Later that year their son begins a new treatment that is available at a hospital 100 miles away from their residence. In 2004 H and W sell their house so that they can be closer to the hospital to facilitate their son's treatment. Because, under the facts and circumstances, the primary reason for the sale is to facilitate the treatment of their son's chronic illness, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B, who has chronic asthma, purchases a house in Minnesota in 2003 that he uses as his principal residence. B's doctor tells B that moving to a warm, dry climate would mitigate B's asthma symptoms. In 2004 B sells his house and moves to Arizona to relieve his asthma symptoms. The sale is within the safe harbor of paragraph (d)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2003 H and W purchase a house in Michigan that they use as their principal residence. H's doctor tells H that he should get more outdoor exercise, but H is not suffering from any disease that can be treated or mitigated by outdoor exercise. In 2004 H and W sell their house and move to Florida so that H can increase his general level of exercise by playing golf year-round. Because the sale of the house is merely beneficial to H's general health, the sale of the house is not by reason of H's health. H and W are not entitled to claim a reduced maximum exclusion under section 121(c)(2).

(e) Sale or exchange by reason of unforeseen circumstances—

(1) In general. A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. A sale or exchange by reason of unforeseen circumstances (other than a sale or exchange deemed to be by reason of unforeseen circumstances under paragraph (e)(2) or (3) of this section) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances.

(2) Specific event safe harbors. A sale or exchange is deemed to be by reason of unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence:

(i) The involuntary conversion of the residence.

(ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h)).

(iii) In the case of a qualified individual described in paragraph (f) of this section--

(A) Death;

(B) The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation (as defined in section 85(b));

(C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);

(D) Divorce or legal separation under a decree of divorce or separate maintenance; or

(E) Multiple births resulting from the same pregnancy.

(3) Designation of additional events as unforeseen circumstances.

The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability and may issue rulings addressed to specific taxpayers identifying other events or situations as unforeseen circumstances with regard to those taxpayers (see Sec. 601.601(d)(2) of this chapter).

(4) Examples. The following examples illustrate the rules of this paragraph (e):

Example 1. In 2003 A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2004. The sale is within the safe harbor of paragraph (e)(2)(ii) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H works as a teacher and W works as a pilot. In 2003 H and W buy a house that they use as their principal residence. Later that year W is furloughed from her job for six months. H and W are unable to pay their mortgage and reasonable basic living expenses for their household during the period W is furloughed. H and W sell their house in 2004. The sale is within the safe harbor of paragraph (e)(2)(iii)(C) of this section and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. In 2003 H and W buy a two-bedroom condominium that they use as their principal residence. In 2004 W gives birth to twins and H and W sell their condominium and buy a four-bedroom house. The sale is within the safe harbor of paragraph (e)(2)(iii)(E) of this section, and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. In 2003 B buys a condominium in a high-rise building and uses it as his principal residence. B's monthly condominium fee is $X. Three months after B moves into the condominium, the condominium association replaces the building's roof and heating system. Six months later, B's monthly condominium fee doubles in order to pay for the repairs. B sells the condominium in 2004 because he is unable to afford the new condominium fee along with a monthly mortgage payment. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the doubling of the condominium fee, is an unforeseen circumstance because B could not reasonably have anticipated that the condominium fee would double at the time he purchased and occupied the property. Consequently, the sale of the condominium is by reason of unforeseen circumstances and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2003 C buys a house that he uses as his principal residence. The property is located on a heavily traveled road. C sells the property in 2004 because C is disturbed by the traffic. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale, the traffic, is not an unforeseen circumstance because C could reasonably have anticipated the traffic at the time he purchased and occupied the house. Consequently, the sale of the house is not by reason of unforeseen circumstances and C is not entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 6. In 2003 D and her fiance E buy a house and live in it as their principal residence. In 2004 D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2004. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the broken engagement, is an unforeseen circumstance because D and E could not reasonably have anticipated the broken engagement at the time they purchased and occupied the house. Consequently, the sale is by reason of unforeseen circumstances and D and E are each entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 7. In 2003 F buys a small condominium that she uses as her principal residence. In 2005 F receives a promotion and a large increase in her salary. F sells the condominium in 2004 and purchases a house because she can now afford the house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, F's salary increase, is an improvement in F's

financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

Example 8. In April 2003 G buys a house that he uses as his principal residence. G sells his house in October 2004 because the house has greatly appreciated in value, mortgage rates have substantially decreased, and G can afford a bigger house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reasons for the sale of the house, the changes in G's house value and in the mortgage rates, are an improvement in G's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

Example 9. H works as a police officer for City X. In 2003 H buys a condominium that he uses as his principal residence. In 2004 H is assigned to City X's K-9 unit and is required to care for the police service dog at his home. Because H's condominium association does not permit H to have a dog in his condominium, in 2004 he sells the condominium and buys a house. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, H's assignment to the K-9 unit, is an unforeseen circumstance because H could not reasonably have anticipated his assignment to the K-9 unit at the time he purchased and occupied the condominium. Consequently, the sale of the condominium is by reason of unforeseen circumstances and H is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 10. In 2003, J buys a small house that she uses as her principal residence. After J wins the lottery, she sells the small house in 2004 and buys a bigger, more expensive house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, winning the lottery, is an improvement in J's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion under section 121(c)(2).

(f) Qualified individual. For purposes of this section, qualified individual means--

(1) The taxpayer;

(2) The taxpayer's spouse;

(3) A co-owner of the residence;

(4) A person whose principal place of abode is in the same household as the taxpayer; or

(5) For purposes of paragraph (d) of this section, a person bearing a relationship specified in sections 152(a)(1) through 152(a)(8) (without regard to qualification as a dependent) to a qualified individual described in paragraphs (f)(1) through (4) of this section, or a descendant of the taxpayer's grandparent.

(g) Computation of reduced maximum exclusion.

(1) The reduced maximum exclusion is computed by multiplying the maximum dollar limitation of $250,000 ($500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale or exchange; or the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

(2) Examples. The following examples illustrate the rules of this paragraph (g):

Example 1. Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in place of her employment. A has not excluded gain under section 121 on a prior sale or exchange of property within the last 2 years. A is eligible to exclude up to $125,000 of the gain from the sale of her house (12/24 x $250,000).

Example 2.

(i) Taxpayer H owns a house that he has used as his principal residence since 1996. On January 15, 1999, H and W marry and W begins to use H's house as her principal residence. On January 15, 2000, H sells the house due to a change in W's place of employment. Neither H nor W has excluded gain under section 121 on a prior sale or exchange of property within the last 2 years.

(ii) Because H and W have not each used the house as their principal residence for at least 2 years during the 5-year period preceding its sale, the maximum dollar limitation amount that may be claimed by H and W will not be $500,000, but the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. (See Sec. 1.121-2(a)(3)(ii).)

(iii) H is eligible to exclude up to $250,000 of gain because he meets the requirements of section 121. W is not eligible to exclude the maximum dollar limitation amount. Instead, because the sale of the house is due to a change in place of employment, W is eligible to claim a reduced maximum exclusion of up to $125,000 of the gain (365/730 x $250,000). Therefore, H and W are eligible to exclude up to $375,000 of gain ($250,000 + $125,000) from the sale of the house.

(h) Effective dates. Paragraphs (a) and (g) of this section are applicable for sales and exchanges on or after December 24, 2002. Paragraphs (b) through (f) of this section are applicable for sales and exchanges on or after August 13, 2004.

Sec. 1.121-4
Special rules.

(a) Property of deceased spouse—

(1) In general. For purposes of satisfying the ownership and use requirements of section 121, a taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death if--

(i) The taxpayer's spouse is deceased on the date of the sale or exchange of the property; and

(ii) The taxpayer has not remarried at the time of the sale or exchange of the property.

(2) Example. The provisions of this paragraph (a) are illustrated by the following example. The example assumes that Sec. 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer H has owned and used a house as his principal residence since 1987. H and W marry on July 1, 1999 and from that date they use H's house as their principal residence. H dies on August 15, 2000, and W inherits the property. W sells the property on September 1, 2000, at which time she has not remarried. Although W has owned and used the house for less than 2 years, W will be considered to have satisfied the ownership and use requirements of section 121 because W's period of ownership and use includes the period that H owned and used the property before death.

(b) Property owned by spouse or former spouse—

(1) Property transferred to individual from spouse or former spouse. If a taxpayer obtains property from a spouse or former spouse in a transaction described in section 1041(a), the period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property.

(2) Property used by spouse or former spouse. A taxpayer is treated as using property as the taxpayer's principal residence for any period that the taxpayer has an ownership interest in the property and the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument (as defined in section 71(b)(2)), provided that the spouse or former spouse uses the property as his or her principal residence.

(c) Tenant-stockholder in cooperative housing corporation. A taxpayer who holds stock as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)) may be eligible to exclude gain under section 121 on the sale or exchange of the stock. In determining whether the taxpayer meets the requirements of section 121, the ownership requirements are applied to the holding of the stock and the use requirements are applied to the house or apartment that the taxpayer is entitled to occupy by reason of the taxpayer's stock ownership.

(d) Involuntary conversions—

(1) In general. For purposes of section 121, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of the property.

(2) Application of section 1033. In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property used as the taxpayer's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from the taxpayer's gross income under section 121.

(3) Property acquired after involuntary conversion. If the basis of the property acquired as a result of an involuntary conversion is determined (in whole or in part) under section 1033(b) (relating to the basis of property acquired through an involuntary conversion), then for purposes of satisfying the requirements of section 121, the taxpayer will be treated as owning and using the acquired property as the taxpayer's principal residence during any period of time that the taxpayer owned and used the converted property as the taxpayer's principal residence.

(4) Example. The provisions of this paragraph (d) are illustrated by the following example:

Example.

(i) On February 18, 1999, fire destroys Taxpayer A's house which has an adjusted basis of $80,000. A had owned and used this property as her principal residence for 20 years prior to its destruction. A's insurance company pays A $400,000 for the house. A realizes a gain of $320,000 ($400,000--$80,000). On August 27, 1999, A purchases a new house at a cost of $100,000.

(ii) Because the destruction of the house is treated as a sale for purposes of section 121, A will exclude $250,000 of the realized gain from A's gross income. For purposes of section 1033, the amount realized is then treated as being $150,000 ($400,000--$250,000) and the gain realized is $70,000 ($150,000 amount realized--$80,000 basis). A elects under section 1033 to recognize only $50,000 of the gain ($150,000 amount realized--$100,000 cost of new house). The remaining $20,000 of gain is deferred and A's basis in the new house is $80,000 ($100,000 cost--$20,000 gain not recognized).

(iii) A will be treated as owning and using the new house as A's principal residence during the 20-year period that A owned and used the destroyed house.

(e) Sales or exchanges of partial interests—

(1) Partial interests other than remainder interests—

(i) In general. Except as provided in paragraph (e)(2) of this section (relating to sales or exchanges of remainder interests), a taxpayer may apply the section 121 exclusion to gain from the sale or exchange of an interest in the taxpayer's principal residence that is less than the taxpayer's entire interest if the interest sold or exchanged includes an interest in the dwelling unit. For rules relating to the sale or exchange of vacant land, see Sec. 1.121-1(b)(3).

(ii) Limitations—

(A) Maximum limitation amount. For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of the partial interests. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and Sec. 1.121-2(a)(3)(i)(relating to the limitation for certain joint returns) apply.

(B) Sale or exchange of more than one principal residence in 2-year period. For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

(2) Sales or exchanges of remainder interests—

(i) In general. A taxpayer may elect to apply the section 121 exclusion to gain from the sale or exchange of a remainder interest in the taxpayer's principal residence.

(ii) Limitations—

(A) Sale or exchange of any other interest. If a taxpayer elects to exclude gain from the sale or exchange of a remainder interest in the taxpayer's principal residence, the section 121 exclusion will not apply to a sale or exchange of any other interest in the residence that is sold or exchanged separately.

(B) Sales or exchanges to related parties. This paragraph (e)(2) will not apply to a sale or exchange to any person that bears a relationship to the taxpayer that is described in section 267(b) or 707(b).

(iii) Election. The taxpayer makes the election under this paragraph (e)(2) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the remainder interest in the taxpayer's gross income. A taxpayer may make or revoke the election at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(3) Example. The provisions of this paragraph (e) are illustrated by the following example:

Example. In 1991 Taxpayer A buys a house that A uses as his principal residence. In 2004 A's friend B moves into A's house and A sells B a 50% interest in the house realizing a gain of $136,000. A may exclude the $136,000 of gain. In 2005 A sells his remaining 50% interest in the home to B realizing a gain of $138,000. A may exclude $114,000 ($250,000--$136,000 gain previously excluded) of the $138,000 gain from the sale of the remaining interest.

(f) No exclusion for expatriates. The section 121 exclusion will not apply to any sale or exchange by an individual if the provisions of section 877(a) (relating to the treatment of expatriates) applies to the individual.

(g) Election to have section not apply. A taxpayer may elect to have the section 121 exclusion not apply to a sale or exchange of property. The taxpayer makes the election by filing a return for the taxable year of the sale or exchange that includes the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. A taxpayer may make an election under this paragraph (g) to have section 121 not

apply (or revoke an election to have section 121 not apply) at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(h) Residences acquired in rollovers under section 1034. If a taxpayer acquires property in a transaction that qualifies under section 1034 (section 1034 property) for the nonrecognition of gain realized on the sale or exchange of another property and later sells or exchanges such property, in determining the period of the taxpayer's ownership and use of the property under section 121 the taxpayer may include the periods that the taxpayer owned and used the section 1034 property as the taxpayer's principal residence (and each prior residence taken into account under section 1223(7) in determining the holding period of the section 1034 property).

(i) [Reserved]

(j) Election to apply regulations retroactively. Taxpayers who would otherwise qualify under Sec. Sec. 1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence before December 24, 2002 but on or after May 7, 1997, may elect to apply Sec. Sec. 1.121-1 through 1.121-4 for any years for which the period of limitation under section 6511 has not expired. The taxpayer makes the election under this paragraph (j) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of these regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

(k) Audit protection. The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence occurring before December 24, 2002 but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the regulations project under section 121 (REG-105235-99 (2000-2 C.B. 447)) generally will be considered a reasonable, good faith effort to comply with the requirements of section 121.

(l) Effective date. This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions retroactively, see paragraph (j) of this section.

REVENUE RULING 67-235

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: 1967

Section 121 â ” Gain From Sale or Exchange of Residence of Individual Who Has Attained Age 65

26 CFR 1.121-1: Limitations.

A brother and sister sell their jointly owned residence. They each qualify in all respects to receive the benefits of section 121 of the Internal Revenue Code of 1954, relating to the exclusion from income of gain from the sale or exchange of a residence of an individual who has attained the age of 65.

Held, each is entitled to exclude from his income for income tax purposes that portion of his gain which bears the same ratio to the total amount of gain attributable to his undivided interest as $20,000 bears to his adjusted sales price. If the adjusted sales price of each undivided interest is not in excess of $20,000, each taxpayer is entitled to exclude his whole gain from income.

REVENUE PROCEDURE 2007-12

SECTION 1. PURPOSE

This revenue procedure supersedes Rev. Proc. 98–20, 98–1 C.B. 549, and sets forth the acceptable form of the written assurances (certification) that a real estate reporting person must obtain from the seller of a principal residence to except the sale or exchange of such principal residence from the information reporting requirements for real estate transactions under § 6045(e)(5) of the Internal Revenue Code (Code). This revenue procedure incorporates amendments to section 121 of the Code made by section 840ofthe American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418 (October 22, 2004) (AJCA), as amended by section 403(ee) of the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109–135, 119 Stat. 2631 (December 21, 2005) (the GO Zone Act).

SECTION 2. BACKGROUND

.01 Section 6045(e) and § 1.6045–4 of the Income Tax Regulations generally require a real estate reporting person (as defined in § 6045(e)(2) and § 1.6045–4(e)) to file an information return regarding a real estate transaction and to furnish a payee statement to the seller regarding that transaction. The information return and statement must include the name, address, and taxpayer identification number (TIN) of the seller, and the gross proceeds of the real estate transaction. This information is reported on Form 1099–S, *Proceeds From Real Estate Transactions* .

.02 Section 312 of the Taxpayer Relief Act of 1997 (TRA 1997), Pub. L. No. 105–34, 111 Stat. 788 (August 5, 1997), as amended by the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 805 (July 22, 1998), effective for sales or exchanges after May 6, 1997, amended § 6045(e) by adding a new paragraph (5), which excepts a sale or exchange of a principal residence from the § 6045(e) information reporting requirements if the seller provides the real estate reporting person with a certification setting forth certain written assurances, including an assurance that the residence is the seller's principal residence (within the meaning of § 121) and an assurance that the full amount of the gain on the sale or exchange of the principal residence is excludable from gross income under § 121.

.03 Section 312 of TRA 1997 also amended §121 to provide new rules for the exclusion of gain on certain sales or exchanges of a principal residence. Section 121, as amended, provides that a taxpayer may exclude from gross income up to $250,000 of gain on the sale or exchange of a principal residence if certain conditions are met. In certain circumstances, a married individual filing a joint return for the taxable year of the sale or exchange may exclude from gross income up to $500,000 of gain. This exclusion also applies to the sale or exchange of stock held by a tenant-stockholder in a cooperative housing corporation (as defined in § 216) and may apply to the sale or exchange of a remainder interest in a principal residence if the taxpayer so elects. *See* Code §§ 121(d)(4) and (d)(8).

.04 Section 840 of the AJCA, as amended by the GO Zone Act, amended § 121 to provide that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired by the taxpayer in a like-kind exchange in which any gain was not recognized under § 1031(a) or (b) within the prior five years.

SECTION 3. SCOPE

This revenue procedure applies to the information reporting requirements under § 6045(e) for a sale or exchange of a principal residence.

SECTION 4. SELLER CERTIFICATION

.01 To be excepted from the information reporting requirements in § 6045(e) on the sale or exchange of a principal residence (including stock in a cooperative housing corporation), the real estate reporting person must obtain from the seller a written certification, signed by the seller under penalties of perjury, that assurances (1) through (6) set forth in section 4.02 of this revenue procedure are true (or, in the case of assurance (6), not applicable). For purposes of this certification, the term "seller" includes each owner of the residence that is sold or exchanged. Thus, if a residence has more than one owner, a real estate reporting person must either obtain a certification from each owner (whether married or not) or file an information return and furnish a payee statement for any owner that does not make the certification.

.02 The assurances are:

(1) The seller owned and used the residence as the seller's principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence.

(2) The seller has not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence.

(3) No portion of the residence has been used for business or rental purposes after May 6, 1997, by the seller (or by the seller's spouse or former spouse, if the seller was married at any time after May 6, 1997).

(4) At least one of the following three statements applies:

The sale or exchange is of the entire residence for $250,000 or less.

OR

The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and the gain on the sale or exchange of the entire residence is $250,000 or less.

OR

The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and (a) the seller intends to file a joint return for the year of the sale or exchange, (b) the seller's spouse also used the residence as his or her principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence, and (c) the seller's spouse also has not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence.

(5) During the 5-year period ending on the date of the sale or exchange of the residence, the seller did not acquire the residence in an exchange to which section 1031 applied.

(6) In cases where the seller's basis in the residence is determined by reference to the basis in the hands of a person who acquired the residence in an exchange to which section 1031 applied, the exchange to which section 1031 applied occurred more than 5 years prior to the date of the seller's sale or exchange of the residence.

SECTION 5. FORMAT FOR MAKING SELLER CERTIFICATION

A sample certification form that may be used by a real estate reporting person to obtain the applicable assurances from the seller is provided in the Appendix of this revenue procedure. Use of this sample certification form is not required. The requirements of the certification under § 6045(e)(5) will be met if the content and wording of a written certification provide the same information as required by section 4 of this revenue procedure.

SECTION 6. OBTAINING AND RETAINING SELLER CERTIFICATION

The real estate reporting person may obtain a certification at any time on or before January 31 of the year following the year of the sale or exchange of the residence. The certification must be retained by the real estate reporting person for 4 years after the year of the sale or exchange of the residence to which the certification applies.

SECTION 7. PENALTIES

A real estate reporting person who relies on a certification made in compliance with this revenue procedure will not be liable for the penalties under § 6721 for failure to file an information return, or under § 6722 for failure to furnish a payee statement to the seller, unless the real estate reporting person has actual knowledge that any assurance is incorrect.

SECTION 8. EFFECT ON OTHER DOCUMENTS (when applicable)

Rev. Proc. 98–20 is superseded.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for sales or exchanges of a principal residence occurring after January 22, 2007.

SECTION 10. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1592.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 4 and 5 of this revenue procedure. This information is required to exempt a real estate reporting person from the requirement to file an information return and furnish a payee statement reporting the sale or exchange of a principal residence. The likely respondents are individual taxpayers who sell or exchange a principal residence and real estate businesses.

The estimated total annual reporting burden for respondents is 383,000 hours.

The estimated burden per respondent is 10 minutes. The estimated number of respondents is 2,300,000. The frequency of responses is on occasion.

The estimated total annual burden for recordkeepers is 37,500 hours.

The estimated annual burden per recordkeeper is 25 minutes. The estimated number of recordkeepers is 90,000.

Books or records relating to a collection of information must be retained as long as their content may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

SECTION 11. DRAFTING INFORMATION

The principal author of this revenue procedure is Timothy S. Sheppard of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue procedure, contact Mr. Sheppard at (202) 622–4910 (not a toll-free call).

APPENDIX

CERTIFICATION FOR NO INFORMATION REPORTING ON THE SALE OR EXCHANGE OF A PRINCIPAL RESIDENCE

This form may be completed by the seller of a principal residence. This information is necessary to determine whether the sale or exchange should be reported to the seller, and to the Internal Revenue Service on Form 1099–S, *Proceeds From Real Estate Transactions* . If the seller properly completes Parts I and III, and makes a "true" response to assurances (1) through (6) in Part II (or a "not applicable" response to assurance (6)), no information reporting to the seller or to the Service will be required for that seller. The term "seller" includes each owner of the residence that is sold or exchanged. Thus, if a residence has more than one owner, a real estate reporting person must either obtain a certification from each owner (whether married or not) or file an information return and furnish a payee statement for any owner that does not make the certification.

Part I. Seller Information

1. Name _____

2. Address or legal description (including city, state, and ZIP code) of residence being sold or exchanged _____

_____

_____

3. Taxpayer Identification Number (TIN) _____

Part II. Seller Assurances

Check "true" or "false" for assurances (1) through (5), and "true", "false", or "not applicable" for assurance (6).

True	False	
[ ]	[ ]	(1) I owned and used the residence as my principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence.
[ ]	[ ]	(2) I have not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence.
[ ]	[ ]	(3) I (or my spouse or former spouse, if I was married at any time during the period beginning after May 6, 1997, and ending today) have not used any portion of the residence for business or rental purposes after May 6, 1997.

True	False	
[ ]	[ ]	(4) At least one of the following three statements applies: The sale or exchange is of the entire residence for $250,000 or less. OR I am married, the sale or exchange is of the entire residence for $500,000 or less, and the gain on the sale or exchange of the entire residence is $250,000 or less. OR I am married, the sale or exchange is of the entire residence for $500,000 or less, and (a) I intend to file a joint return for the year of the sale or exchange, (b) my spouse also used the residence as his or her principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence, and (c) my spouse also has not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the principal residence.
[ ]	[ ]	(5) During the 5-year period ending on the date of the sale or exchange of the residence, I did not acquire the residence in an exchange to which section 1031 of the Internal Revenue Code applied.

True	False	N/A	
[ ]	[ ]	[ ]	(6) If my basis in the residence is determined by reference to the basis in the hands of a person who acquired the residence in an exchange to which section 1031 of the Internal Revenue Code applied, the exchange to which section 1031 applied occurred more than 5 years prior to the date I sold or exchanged the residence.

Part III. Seller Certification

Under penalties of perjury, I certify that all the above information is true as of the end of the day of the sale or exchange.

Signature of Seller	Date

REVENUE PROCEDURE 2005-14

SECTION 1. PURPOSE

This revenue procedure provides guidance on the application of §§ 121 and 1031 of the Internal Revenue Code to a single exchange of property.

SECTION 2. BACKGROUND

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to $250,000 ($500,000 for certain joint returns). Under § 121(d)(6), any gain attributable to depreciation adjustments (as defined in § 1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the § 121 exclusion applies. See § 121–1(d)(1).

.02 Section 121(d), as amended by § 840 of the American Jobs Creation Act of 2004, Pub. L. 108–357, provides that, if a taxpayer acquired property in an exchange to which § 1031 applied, the § 121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property. This provision is effective for sales or exchanges after October 22, 2004.

.03 Under § 1.121–1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term "dwelling unit" has the same meaning as in § 280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.04 Section 1.121–1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method of allocating the basis and the amount realized. *Poague v. United States* , 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), *aff'd* , 947 F.2d 942 (4th Cir. 1991).

.05 Section 1031(a) 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 (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under § 1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under § 1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.06 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, § 1031(d)). See *Philadelphia Park Amusement Co. v. United States* , 126 F. Supp. 184 (Ct. Cl. 1954).

.07 Under § 1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.08 Neither § 121 nor § 1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying § 121 and another nonrecognition provision, § 1033, to a single replacement of property. Under § 1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.09 Section 121(d)(5)(B) provides that, in applying § 1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to § 121, reduced by the amount of gain excluded under § 121. Under § 121(d)(5)(B), the amount realized from an exchange of a taxpayer's principal residence for purposes of applying § 1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under § 121. Thus, Congress concluded that for exchanges meeting the requirements of both § 121 and § 1033, (1) the § 121 exclusion should be applied to gain from the exchange before the application of § 1033, (2) for purposes of determining gain that may be deferred under § 1033, the § 121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of § 121), and (3) the gain excluded under § 121 should be added in the calculation of the taxpayer's basis in the replacement property. See S. Rep. No. 830, 88th Cong., 2d Sess. 52–53, 1964–1 C.B. (Part 2) 505, 556–7 ("the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is rein-vested in the new residence"); H.R. Rep. No. 749, 88th Cong., 1st Sess. 47, 1964–1 C.B. (Part 2) 125, 171.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain on the exchange of like-kind properties under § 1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of § 1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

SECTION 4. APPLICATION

.01 *In general* . Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain from the exchange of like-kind properties under §1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 *Computation of gain* .

(1) *Application of § 121 before § 1031* . Section 121 must be applied to gain realized before applying § 1031.

(2) *Application of § 1031 to gain attributable to depreciation* . Under § 121(d)(6), the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, § 1031 may apply to such gain.

(3) *Treatment of boot* . In applying § 1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under § 121 with respect to the relinquished business property.

.03 *Computation of basis* . In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under § 121 is treated as gain recognized by the taxpayer. Thus, under § 1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under § 121.

SECTION 5. EXAMPLES

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of § 1031(a) as well as used as a principal residence as required under § 121.

Example 1 . (i) Taxpayer A buys a house for $210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of $20,000. In 2006, A exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that A intends to rent to tenants. A realizes gain of $280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§ 121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under § 121. Because the house is investment property at the time of the exchange, A may defer gain under § 1031.

(iii) Under section 4.02(1) of this revenue procedure, A applies § 121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of § 1031. A may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under § 1031. See section 4.02(2) of this revenue procedure. Although A receives $10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows.

Amount realized	.....	$470,000
Less:	Adjusted basis	$190,000
	Realized gain	$280,000
Less:	Gain excluded under § 121	$250,000
	Gain to be deferred	$30,000

(iv) A's basis in the replacement property is $430,000, which is equal to the basis of the relinquished property at the time of the exchange ($190,000) increased by the gain excluded under § 121 ($250,000), and reduced by the cash A receives ($10,000)). See section 4.03 of this revenue procedure.

Example 2 . (i) Taxpayer B buys a property for $210,000. The property consists of two separate dwelling units (within the meaning of § 1.121–1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of $30,000 for the business use. B realizes gain of $180,000 on the exchange.

(ii) Under § 121, B may exclude gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guest-house under § 1.121–1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$100,000	$100,000	
Gain deferred under § 1031	$ 80,000		$ 80,000

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under § 121 and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange ($40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000).

Example 3 . (i) Taxpayer C buys a property for $210,000. The property consists of a house that constitutes a single dwelling unit under § 1.121–1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is $360,000. The fair market value of the replacement residence is $240,000 and the fair market value of the replacement business property is $120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of $30,000 for the business use. C realizes gain of $180,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis, which is 1/3 of $210,000 basis, or $70,000, adjusted by $30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies § 121 before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain ($30,000) attributable to depreciation deductions, but may defer the remaining gain of $30,000 under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$150,000	$100,000	$ 50,000
Gain deferred under § 1031	$ 30,000		$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $90,000, which is equal to C's basis in the relinquished business property at the time of the exchange ($40,000), increased by the gain excluded under § 121 attributable to the relinquished business property ($50,000). See section 4.03 of this revenue procedure.

Example 4 . (i) The facts are the same as in *Example 3* except that C also receives $10,000 of cash in the exchange and the fair market value of the replacement business property is $110,000, which is $10,000 less than the fair market value of the business portion of the relinquished property ($120,000).

(ii) Under § 121, C may exclude the gain of $100,000 allocable to the residential portion of the house (2/3 of $360,000 amount realized, or $240,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $80,000 (1/3 of $360,000 amount realized, or $120,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies § 121 to exclude gain before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $50,000 of the gain allocable to the business portion of the house but may not exclude the $30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the $30,000 of gain under § 1031. Although C

receives $10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$360,000	$240,000	$110,000 + 10,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under § 121	$150,000	$100,000	$ 50,000
Gain deferred under § 1031	$ 30,000		$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000). C's basis in the replacement business property is $80,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the gain excluded under § 121 ($50,000), and reduced by the cash ($10,000) received. See section 4.03 of this revenue procedure.

Example 5 . (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $540,000. The fair market value of the replacement residence is $360,000, the fair market value of the replacement business property is $180,000, and C realizes gain of $360,000 on the exchange.

(ii) Under § 121, C may exclude the gain of $220,000 allocable to the residential portion of the house (2/3 of $540,000 amount realized, or $360,000, minus 2/3 of $210,000 basis, or $140,000).

(iii) The remaining gain of $140,000 (1/3 of $540,000 amount realized, or $180,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of § 1031. Under § 1.121–1(e), C may exclude $30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of $250,000. C may defer the remaining gain of $110,000 ($140,000 realized gain minus the $30,000 gain excluded under § 121), including the $30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$540,000	$360,000	$180,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$360,000	$220,000	$140,000
Gain excluded under § 121	$250,000	$220,000	$ 30,000
Gain deferred under § 1031	$110,000		$110,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($360,000). C's basis in the replacement business property is $70,000, which is equal to C's basis in the relinquished business property ($40,000), increased by the amount of the gain excluded under § 121 ($30,000). See section 4.03 of this revenue procedure.

Example 6 . (i) The facts are the same as in *Example 3* except that the total fair market value of the replacement properties is $750,000. The fair market value of the replacement residence is $500,000, the fair market value of the replacement business property is $250,000, and C realizes gain of $570,000 on the exchange.

(ii) The gain allocable to the residential portion is $360,000 (2/3 of $750,000 amount realized, or $500,000, minus 2/3 of $210,000 basis, or $140,000). C may exclude gain of $250,000 from gross income under § 121. C must include in income the gain of $110,000 allocable to the residential portion that exceeds the § 121(b) exclusion limitation amount.

(iii) The remaining gain of $210,000 (1/3 of $750,000 amount realized, or $250,000, minus $40,000 adjusted basis) is allocable to the business portion of the house. C may defer the $210,000 of gain, including the $30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized	$750,000	$500,000	$250,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$570,000	$360,000	$210,000
Gain excluded under § 121	$250,000	$250,000	
Gain deferred under § 1031	$210,000		$210,000
Gain recognized	$110,000	$110,000	

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($500,000). C's basis in the replacement business property is $40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under § 6511 has not expired.

DRAFTING INFORMATION

The principal author of this revenue procedure is Sara Paige Shepherd of the Office of Associate Chief Counsel (In-come Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Shepherd at (202) 622–4960 (not a toll-free call).

PRIVATE LETTER RULING 200725018

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: June 22, 2007
March 15, 2007

Section 121 — One Time Exclusion of Gain from Sale of Principal Residence

Legend:

Taxpayer A =
Taxpayer B =
Residence 1 =
Residence 2 =
Residence 3 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
X =

Dear ***:

This letter is a response to your request for a ruling under section 121(c) of the Internal Revenue Code. Specifically, you have requested a ruling that the gain on the sale of Residence 2 may be excluded under the reduced maximum exclusion in section 121(c).

Facts

On Date 1, Taxpayer A purchased Residence 1. On Date 2, Taxpayer B purchased Residence 2. After the purchase of these residences, Taxpayer A and Taxpayer B met and later married on Date 3. Taxpayer A and Taxpayer B purchased Residence 3 on Date 4 shortly after their marriage. About a month later, Taxpayer A sold residence 1 on Date 5, and Taxpayer B sold Residence 2 on Date 6. Taxpayer B held Residence 2 less than two years, about X months.

Residence 1 and Residence 2 each had three bedrooms. Residence 3 has four bedrooms. Taxpayer A has three children from a previous marriage, and Taxpayer B has two children from a previous marriage. Residence 3 allows Taxpayers A and B to provide suitable bedroom arrangements for their blended family, which includes adolescent children of the opposite sex.

Law and Analysis

Section 121(a) provides that gain from the sale or exchange of property is not included in gross income if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and used the property as the taxpayer's principal residence for periods aggregating two years or more. Section 121(b)(1) states the general rule for the maximum exclusion of gain. Section 121(b)(3) provides that subsection (a) shall not apply to any sale if, during the 2-year period ending on the date of the sale, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

Section 121(c) provides for a reduced maximum exclusion when a taxpayer fails to satisfy the ownership and use requirements of subsection (a) if the primary reason for the sale is the occurrence of unforeseen circumstances.

The reduced maximum exclusion is computed by multiplying the applicable maximum exclusion by a fraction. The numerator of the fraction is the shortest of the following periods: (1) the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale; (2) the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale; or (3) the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

Section 1.121-3(b) of the Income Tax Regulations provides that all the facts and circumstances of a sale will determine whether the primary reason for the sale is the occurrence of unforeseen circumstances. Factors that may be relevant in determining the primary reason for a sale include the following: (1) the suitability of the property as the taxpayer's residence materially changes; (2) the circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and (3) the circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Section 1.121-3(e)(1) provides that a sale is by reason of unforeseen circumstances if the primary reason for the sale is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. Section 1.121-3(e)(3) states that the Commissioner may issue rulings addressed to specific taxpayers identifying events or situations as unforeseen circumstances with regard to those taxpayers.

In the present case, based on the facts, representations, and the relevant law, we conclude that the occurrence of unforeseen circumstances was the primary reason for the sale of Residence 2 by Taxpayer B on Date 6. When Taxpayer B purchased and began using Residence 2 as his principal residence, he had not met Taxpayer A. He met and married Taxpayer A during the period of his ownership and use of Residence 2. As a consequence of the marriage, the suitability of Residence 2 as B's principal residence materially changed. Taxpayer A and Taxpayer B needed a larger home with more bedrooms to suitably accommodate their blended family. The occurrence of Taxpayer B's marriage to Taxpayer A and the need to suitably accommodate their blended family were unforeseen circumstances. The occurrence of these unforeseen circumstances was the primary reason for the sale of Residence 2 by Taxpayer B.

Accordingly, the gain on the sale of Residence 2, which Taxpayer B owned and used as a principal residence for less than two of the preceding five years, may be excluded under the reduced maximum exclusion of gain in section 121(c).

Caveats

Except as expressly provided, we express no opinion 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 taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, we are sending a copy of this letter to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, a taxpayer filing a return electronically may satisfy this requirement by attaching a statement to the 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 the taxpayer and accompanied by a penalty of perjury statement executed by the taxpayer. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

Sincerely,

Donna Welch
Senior Technician Reviewer
Branch 4 (Income Tax & Accounting)

PRIVATE LETTER RULING 200702032

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: January 12, 2007
September 29, 2006

Section 121 — One Time Exclusion of Gain from Sale of Principal Residence

LEGEND:
Taxpayer =
Date 1 =
Date 2 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
City =
State
Property =
A =
$ a =
$ b =
$c =
$d =
$e =
$ f =
$g =
Notice =
Airport Authority =

Dear ***:
This responds to your letter dated November 22, 2005, requesting rulings on whether your settlement proceeds should be treated as gain from the sale of a principal residence and, if so, whether you are eligible to exclude the gain under Section 121(c) of the Internal Revenue Code. You supplemented your request with letters and additional materials on April 26, 2006, and on September 20, 2006.

FACTS:

In Year 1, Taxpayer moved into the City. The City, located in State, is serviced by Airport. When Taxpayer first moved into the City metropolitan area, he lived in an apartment, located approximately A miles from Airport. On Date 1, Taxpayer purchased Property, also located about A miles from Airport, for $a. Taxpayer represents that he owned and used Property as his principal residence for slightly more than 20 months.

On Date 2, Taxpayer sold Property to an unrelated purchaser. Taxpayer's gross proceeds on the sale were $b; his amount realized, after paying a sales commission of $c, was $d. Taxpayer thus realized a nondeductible loss of $e ($d minus $a) on the sale of Property in Year 3, which Taxpayer properly did not claim on his Year 3 federal income tax return.

Shortly after purchasing and occupying Property, Taxpayer realized there was substantial noise from airplanes flying overhead during peak flight periods (early mornings and early evenings). Taxpayer represents that had he known or been advised how noisy the flight traffic would be, he would not have purchased Property. In Year 2, after Taxpayer had unsuccessfully sought to rescind the sale, he brought a civil action for damages against the sellers, their real estate agent, his own real estate agent, and the agencies with which the realtors were associated, arguing that the defendants had a duty to disclose the airport noise prior to the sale. In Year 4, the defendants paid Taxpayer $f in settlement of the litigation.

Under the law of State, sellers are expressly required to disclose noise from commercial nuisances affecting residential property and any notice from a governmental agency which may affect title to property. Residential property owners within the noise impact zone surrounding Airport also receive a specific Notice from the Airport Authority. The Notice advises such owners that: (1) their property is exposed to average aircraft noise levels which exceed typical ground-based, or background, noise; (2) State law requires sellers of property to disclose "any governmental notice affecting the property;" (3) the Notice is a governmental notice; (4) the Notice serves as a notice of potential aircraft noise impact upon the recipients' property; and (5) the Notice of potential noise impact should be disclosed to all prospective purchasers who may be considering use of the property for a residential purpose.

Taxpayer represents, and the material he submitted shows, that: (1) he had specifically advised his agent that he wanted to be away from a major highway or road and had rejected one home he was shown because of road noise; (2) he had briefly visited the Property a total of about 10 times, at different times of day and during both weekdays and the weekend; (3) he had not heard airplane traffic on any of those visits; (4) he had discussed the prevalence of noise with residents in the area before buying Property; and (5) he did not receive from the sellers or real estate agents the notice of potential airport noise expressly required by State law.
As noted above, the distances between the apartment and Airport, and between Property and Airport, were approximately the same. However, the apartment is located southeast of Airport, whereas Property is southwest of Airport. Due to this directional difference, residents of the subdivision in

which Property is located are subject to significantly more airport noise than are residents of the apartment. An affidavit from an Airport Authority official obtained by Taxpayer in connection with his lawsuit against the seller and the real estate agents contains information to the effect that the subdivision in which Property was located was subject to five times more sound energy than was the area surrounding the apartment. This difference was due to the direction of Airport's runways. The official's affidavit also provides explanations of how it is possible for someone to briefly visit the subdivision in which Property is located and not hear aircraft noise.

Taxpayer has asked us to rule that the settlement proceeds received in Year 4 should be treated in the same manner as proceeds from the sale of his principal residence. Second, Taxpayer requests us to rule that the sale of Property was due to unforeseen circumstances and that any gain realized on the sale is excluded under Section 121(c).

LAW AND ANALYSIS:

A. Treatment of the settlement proceeds

In determining how settlement proceeds should be taxed, the Service and the courts generally ask, in lieu of what was the settlement amount paid? McKay v. Commissioner, 102 T.C. 465, 482 (1994); Robinson v. Commissioner, 102 T.C. 116, 126 (1994); Church v. Commissioner, 80 T.C. 1104, 1109 (1983); Raytheon Production Co. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944). In determining the nature of the claim and thus the taxability of the proceeds, the most important factor to consider is the intent of the payor, considering all the facts and circumstances. Allen v. Commissioner, TC Memo 1998-406 (1998), citing Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965), affg. T.C. Memo 1964-33. The essential question in such a case is: What is "the basic reason for the ... payment," Agar v. Commissioner, 290 F.2d 283 (2d Cir. 1961).

Determining the payor's intent is a factual inquiry that requires consideration of all factors involved in resolving the claim, including the parties' allegations, evidence, arguments, and the terms of any settlement. In the present case, the pleadings consistently reflect Taxpayer's claims that the defendants failed to disclose that Property was affected by airport noise and that he was entitled to damages as a consequence of the failure to disclose. In effect, Taxpayer argued that his home was less valuable than he thought because of the airport noise. Thus, in our view, Taxpayer's lawsuit was directly tied to the property purchased by taxpayer and the proceeds he received should be treated in the same manner as proceeds from the sale of Property.

Arrowsmith v. Commissioner, 344 U.S. 6 (1952), also is instructive in determining the tax treatment of the settlement proceeds. Arrowsmith involved two taxpayers who in 1937 decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership. All distributions were made by 1940 and the taxpayers properly reported the profits obtained from the distributions as capital gains. In 1944, a judgment was rendered against the old corporation and against one of the taxpayers, individually. The two taxpayers, as transferees of the corporation's assets, were required to and did pay the judgment for the corporation. The taxpayers argued that because (1) each taxable year stands on its own under the annual accounting principle, and (2) there was no sale or exchange in 1944, they were entitled to an ordinary business deduction in that year. This view was rejected by the Court, however, which accepted the Service's position that the loss was capital because it was part of the original liquidation transaction (and, in essence, was a diminution of the original proceeds).

The Court agreed that the returns from 1937 through 1940 should not be re-opened and readjusted, but rejected the argument that annual accounting required ordinary loss treatment in 1944. In essence, by holding that characterization of a later-year transaction was determined in correlation with a prior-year transaction, the Court dispensed with the need for an actual (or deemed) sale or exchange in the later year.

Arrowsmith has been applied in many cases and rulings. In particular, see Kimbell v. United States, 490 F.2d 203 (1974), cert. denied, 419 U.S. 833 (1974) (sale of interest in oil and gas leases resulted in capital gain; taxpayer's subsequent-year settlement of claim involving illegal slanting of wells treated as capital loss by reference to prior-year transaction, rather than as a deduction against ordinary income for payment of an ordinary and necessary business expense); and Rev. Rul. 79-278, 1979-2 C.B. 302 (corporation which incurred a short-term capital loss on sale of stock entitled to treat settlement proceeds in later year as short-term capital gain).

Viewed in isolation, the settlement proceeds received by Taxpayer in Year 4 would be ordinary income because there was no sale or exchange. However, under Arrowsmith and the other case law discussed above, the Year 4 settlement proceeds are characterized by reference to the sale transaction occurring in Year 3, and thus are treated as proceeds from the sale of a principal residence held for more than one year by Taxpayer. Accordingly, $e of the settlement proceeds received by Taxpayer is a return of capital and not includible in his gross income. The remaining portion of the proceeds, $g, is treated in Year 4 as gain from the sale of a principal residence.

B. Section 121.

Taxpayer also argues that the sale of Property was due to unforeseen circumstances and that any gain realized on the sale (including the settlement proceeds treated as gain) is excluded under Section 121(c).

Section 121(a) provides that a taxpayer's gross income will not include gain from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. The full exclusion is available only once every two years.

Section 121(b) provides that the maximum exclusion amount is $250,000 ($500,000 for married taxpayers). Section 121(c) provides for a reduced maximum exclusion for taxpayers who fail to satisfy the ownership and use tests or the limit of one sale every two years if the primary reason for sale or exchange is a change in place of employment, health, or unforeseen circumstances.

The reduced maximum exclusion is computed by multiplying the maximum dollar limitation of $250,000 ($ 500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the following periods: (1) the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange, (2) the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5- year period ending on the date of the sale or exchange, or (3) the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

Section 1.121-3T(b) of the temporary Income Tax Regulations provides the following factors for determining the taxpayer's primary reason for the sale: (1) the extent to which the sale and the circumstances giving rise to the sale are proximate in time; (2) the suitability of the property as the taxpayer's principal residence materially changes; (3) the taxpayer's financial ability to maintain the property is materially impaired; (4) the taxpayer uses the property as the taxpayer's residence during the period of ownership of the property; (5) the circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and (6) the circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Under Section 1.121-3T(e)(1), a sale is by reason of unforeseen circumstances if the primary reason for the sale "is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence." Example 5 of Section 1.121-3T(e)(4) illustrates a situation in which a taxpayer did not meet the unforeseen circumstances test. In Example 5, C buys a house that he uses as his principal residence. The property is located on a heavily-traveled road. C sells the property before two years has elapsed because he is disturbed by the traffic. The example concludes that C is not entitled to claim a reduced maximum exclusion under the unforeseen circumstances exception, because the primary reason for the sale was the traffic and C could reasonably have anticipated the traffic at the time he purchased and occupied the house.

We believe that Taxpayer conducted a reasonable investigation of Property and did not anticipate the airport noise before purchasing and occupying Property, as provided in Section 1.121-3T(e)(1). Moreover, Example 5 of Section 1.121-3T(e)(4) is distinguishable from the facts of the present case. First, Property was the same distance from Airport as was the apartment from which Taxpayer moved, and the apartment was not affected by airport noise. Second, Taxpayer's visits to Property did not put him on actual notice of airport noise. Taxpayer's statement that he visited Property on multiple occasions without hearing such noise was buttressed by the affidavit of the Airport Authority official, which provided explanations why such noise might not occur during a series of brief visits. Also, prior to his purchase of Property, Taxpayer talked to future neighbors who did not mention the airport noise. Third, Taxpayer did not receive the required governmental notice from the sellers or the real estate agents, a notice expressly designed to alert prospective purchasers that Property was located within the noise impact zone and thus adversely affected by airport noise. Finally, we accept Taxpayer's assertion that he would not have purchased Property had he known of the airport noise.

Additionally, Example 5 of Section 1.121-3T(e)(1) is distinguishable from the facts of the present case. Taxpayer did not move next to Airport in the same way the taxpayer in Example 5 moved next to a heavily-traveled highway. The taxpayer in the example clearly anticipated some noise, just not as much as was actually experienced. In contrast, Taxpayer did not anticipate airport noise when he purchased Property. As the affidavit from the Airport official demonstrates, the difference in noise between the apartment and Property is a function of the runways' orientation. Thus, the difference in airport noise was due not to Taxpayer's distance from Airport, but rather, direction. This fact supports Taxpayer's contention that he did not anticipate any airplane noise at all.

Based on the facts, representations, and the relevant law as set forth above, we rule as follows:

1. The settlement proceeds are to be treated as proceeds from the sale of a principal residence held for more than a year by Taxpayer. Thus, $e of the settlement proceeds received by Taxpayer is a return of capital and not includible in his gross income. The remaining portion of the proceeds, $g, is treated as gain from the sale of a principal residence.

2. Taxpayer's primary reason for the sale of Property was an unforeseen circumstance. Consequently, Taxpayer is allowed to exclude the $g of gain under Section 121(c) in Year 4.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under Section 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. In addition, no opinion is expressed or implied as to whether Taxpayer has used Property as his principal residence.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200652041

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: December 29, 2006
September 30, 2006

Section 121 — One Time Exclusion of Gain from Sale of Principal Residence

LEGEND:

Taxpayer A :
Taxpayer B :
Residence :
Month 1 :
Month 2 :
Year 1 :
Year 2 :

Dear ***:

This responds to a letter received on August 12, 2004, requesting a ruling on whether the taxpayers may exclude gain from the sale of the Residence under section 121(c) of the Internal Revenue Code.

FACTS

Unmarried Taxpayers A and B jointly purchased the Residence in Month 1, Year 1, using the property as their principal residence. In Month 2, Year 2, approximately seven months after purchasing the Residence, Taxpayer A discovered that she was one-month pregnant. Taxpayer A and the father of the expected child are no longer in a relationship.

According to their representations, Taxpayers A and B plan to sell the Residence and find separate residences because the Residence is not large enough to accommodate two adults and a child and neither A nor B can afford to make the monthly mortgage payments on the Residence alone.

LAW & ANALYSIS

Section 121(a) of the Code provides that a taxpayer's gross income will not include gain from the sale of property if, during the five-year period ending on the date of the sale, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. The full exclusion is available only once every two years.

Section 1.121-2(a)(2) of the Income Tax Regulations provides that if taxpayers jointly own a principal residence but file separate returns, each taxpayer may exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property, if the requirements of section 121 have otherwise been met.

Section 1.121-3(a) of the regulations provides for taxpayers who fail to satisfy the ownership and use tests or the limit of one sale every two years, section 121(c) of the Code provides for a reduced maximum exclusion if the primary reason for the sale is a change in place of employment, health, or unforeseen circumstances.

Section 1.121-3(e) of the regulations provides that a sale is by reason of unforeseen circumstances if the primary reason for the sale is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. A taxpayer's reason for the sale is deemed to be unforeseen circumstances if one of the safe harbor events, such as death, divorce, or multiple births from the same pregnancy, occurs during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence. In addition, the Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability or may issue rulings addressed to specific taxpayers identifying other events or situations as unforeseen circumstances with regard to those taxpayers.

Section 1.121-3(b) of the regulations provides that if a safe harbor does not apply, a sale is by reason of unforeseen circumstances only if the primary reason for the sale is unforeseen circumstances. Factors that may be relevant in determining the taxpayer's primary reason for the sale include (but are not limited to) the extent to which (1) the sale and the circumstances giving rise to the sale are proximate in time; (2) the suitability of the property as the taxpayer's principal residence materially changes; (3) the taxpayer's financial ability to maintain the property is materially impaired; (4) the taxpayer uses the property as the taxpayer's residence during the period of ownership of the property; (5) the circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and (6) the circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Section 1.121-3(g) of the regulations provides that the reduced maximum exclusion is computed by multiplying the maximum dollar limitation of $250,000 ($500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the following periods: (1) the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange, (2) the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale or exchange, or (3) the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under Section 121 and the date of the current sale or

exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

Based on the facts as represented and the relevant law as set forth above, we conclude that for Taxpayers A and B, the primary reason for the sale of the Residence will be an unforeseen circumstance. Consequently, if Taxpayers A and B sell the Residence after they have owned and used it as their principal residence for less than two of the preceding five years, A and B may exclude gain up to the reduced maximum exclusion amount under section 121(c) of the Code.

Except as specifically ruled upon above, no opinion is expressed or implied regarding the income tax consequences of any transaction, or any item discussed or referenced in this letter. In addition, no opinion is expressed or implied as to whether Taxpayer A and B have used the Residence as their principal residence.

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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayers.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
(Income Tax & Accounting)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 200645001

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: November 10, 2006
July 26, 2006

Section 216 — Deduction Of Taxes, Interest, And Business Depreciation By Cooperative Housing Corporation Tenant-Stockholder

LEGEND:

Corporation =
Location =
Year 1 =
n =
o =
p =
q =
r =
s =
t =
u =
v =
w =
x =
y =
State =
Event =
z =

Dear ***:

This letter is in response to the letter from your authorized representative dated December 30, 2004, and subsequent correspondence, requesting rulings under Section 216 of the Internal Revenue Code.

The facts are represented to be as follows. Corporation is a cooperative housing corporation located in Location. Corporation was formed in Year 1 by the developer of the property. Corporation owns n disconnected towers of o floors, which sit on approximately p acres of land. There are a total of q units in the buildings, which range in size from r to s square feet, with an average size of t to u square feet. Approximately v of the units have been held as the principal residence of a tenant-stockholder for at least 2 years. Approximately w of the units have been held as the principal residence of a tenant-stockholder for less than 2 years. Between x and y of the units are rented to third parties by tenant-stockholders. A few units are held as a second residence by a tenant-stockholder. The initial proprietary leases for the units had a 99 year term, which is the longest allowable under State law. Corporation further represents that it complies with all of the requirements of Section 216(b)(1).

As a result of Event, Corporation's buildings sustained substantial damage. The extensive repair and renovation of the buildings took many years and was in excess of the Corporation's insurance. Corporation incurred nearly $z of debt to pay for the repair and renovation, including the refinancing of some of Corporation's pre-existing debt.

Corporation has proposed to subdivide the buildings into condominium units, and distribute some of the condominium units to tenant-stockholders in exchange for the redemption of their stock and the cancellation of the related proprietary leases. Tenant-stockholders who do not participate in the redemption will continue to own stock in Corporation, which will continue to operate as a cooperative housing corporation. However, tenant-stockholders who do not initially participate in the redemption will have the opportunity to participate in the future. After the plan is approved by the tenant-stockholders, Corporation will obtain the required approvals of the relevant state and local authorities. Each tenant-stockholder will be responsible for paying their portion of the debt on the property, their portion of the cost of the conversion, and their portion of any corporate level tax arising from the conversion. Corporation's board will review requests from any tenant-stockholder that wish to have their stock redeemed in exchange for their unit. In deciding whether to approve the conversion, the board will consider all relevant factors including whether the unit was used as the tenant-stockholder's principal residence, the number of requests received, the ability of the tenant-stockholder to pay the costs of conversion, and the cost to Corporation of the conversion. Each tenant-stockholder who uses their unit as their principal residence will be entitled to the conversion subject to providing such documentation, indemnification, or security as the board requires. Corporation shall complete the conversion within 60 days of the approval of the tenant-stockholder's request.

Corporation requests the following rulings:

(1) Corporation will recognize no gain or loss upon the subdivision of the buildings into condominiums.

(2) Corporation will recognize no gain or loss on the distribution of the condominiums to tenant-stockholders who utilize their units as their principal residences.

(3) For purposes of Section 216(e), a tenant-stockholder's unit shall be considered the tenant-stockholder's principal residence so long as the residence satisfies the definition provided in Section 1.121-1(b) without the necessity of also satisfying the two-year home and use requirement provided in Section 121(a).

(4) Corporation will recognize gain in an amount equal to the amount the fair market value of the distributed units exceed the adjusted basis of the units in the hands of Corporation on the distribution of units to tenant-stockholders who do not utilize their units as their principal residence.

(5) Corporation will not be disqualified as a "cooperative housing corporation" within the meaning of Section 216(b)(1) with respect to any distribution of a unit to a tenant-stockholder in exchange for all of the tenant-stockholder's stock in Corporation and the cancellation of the related proprietary lease.

(6) Corporation will continue to qualify as a "cooperative housing corporation" within the meaning of Section 216(b)(1) even though, in accordance with the plan of conversion, Corporation will own a number of condominiums rather than the undivided buildings.

(7) No gain or loss shall be recognized by each tenant-stockholder who exchanges their stock in Corporation and cancels the related proprietary lease in exchange for a unit that is used as the tenant-stockholder's principal residence.

(8) Each tenant-stockholder who exchanges their stock in Corporation and cancels the related proprietary lease for a unit that is used as the tenant-stockholder's principal residence shall have the same basis in the unit as the tenant-stockholder had in their stock in Corporation.

(9) Each tenant-stockholder who exchanges their stock in Corporation and cancels the related proprietary lease for a unit that is used as the tenant-stockholder's principal residence shall have the same holding period in the unit as the tenant-stockholder had in their stock in Corporation.

(10) For purposes of valuing each unit to be distributed to a tenant-stockholder by Corporation, the proprietary lease encumbering the unit and held by the tenant-stockholder shall be taken into account by Corporation and the tenant-stockholder.

(11) Amounts considered to be contributions of capital excluded from income pursuant to Section 118 shall not be considered gross income for purposes of the "80 percent gross income" test set forth in Section 216(b)(1)(D).

RULING REQUEST # 1

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in Section 1011 for determining gain and the loss is the excess of the adjusted basis provided in Section 1011 for determining loss over the amount realized. Under Section 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

A partition of jointly owned property, or a change in the form of ownership from joint tenancy to tenancy in common, is not a sale or other disposition of property. Rev. Rul. 56-437, 1956-2 C.B. 507. Likewise, subdividing a tract of land into sub-lots is not a taxable disposition of property under Section 1001. See Rev. Rul. 70-7, 1970-1 C.B. 175.

Therefore, we hold that the conversion of Corporation's cooperative housing apartments into condominium units will not be considered a sale, exchange or other disposition of property. Thus, the Taxpayer will recognize no gain or loss on the conversion.
RULING REQUEST # 2 and # 3

Section 216(e) provides that, except as provided in regulations, no gain or loss shall be recognized on the distribution by a cooperative housing corporation of a dwelling unit to a stockholder in such corporation if such distribution is in exchange for the stockholder's stock in such corporation and such dwelling unit is used as his principal residence (within the meaning of section 121).

Section 121(a) provides that gross income will not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

The phrase "used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more" in Section 121(a) constitutes a two-prong test. See Guinan v. United States, 2003-1 USTC (CCH) P50,475 (D. Ariz. 2003). First, Section 121(a) requires the taxpayer to use the property as the taxpayer's principal residence. Determining whether a property is the taxpayer's principal residence requires an analysis of the relevant facts and circumstances ("facts and circumstances test"). Section 1.121-1(b)(2) of the Income Tax Regulations. After the taxpayer's principal residence has been determined, the days that the taxpayer's occupied the principal residence are added up to determine whether the taxpayer has used the principal residence for the requisite two years.

The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 836 (1997)(TRA 1997), amended Sections 216 and 121 and repealed Â§ 1034. Prior to its amendment under TRA 1997, Section 216(e) provided that "no gain or loss shall be recognized ... if such exchange qualifies for nonrecognition of gain under Section 1034(f)." Former Section 1034 provided that gain from the sale or exchange of a principal residence (old residence) was recognized only to the extent that the taxpayer=s adjusted sales price of the old residence exceeded the taxpayer=s cost of purchasing a new residence within the replacement period (generally 2 years before or after the date of sale). Under former Section 1034, whether property qualified as a taxpayer's principal residence was determined on the date of the sale or exchange applying a facts and circumstances test. See former Section 1.1034- 1(c)(3) of the Income Tax Regulations. Although reference to Section 1034 in Section 216(e) has been replaced with a reference to

Section 121, TRA 1997 does not demonstrate Congressional intent to modify the limitation of nonrecognition at the corporate level to the extent that the shareholder's unit qualifies as the shareholder's principal residence under the facts and circumstances test. Thus, for purposes of Section 216(e), a shareholder's unit will be considered the shareholder's principal residence if the residence is the shareholder's principal residence under the facts and circumstances test as provided in Section 1.121-1(b) of the regulations without the necessity of also satisfying the two-year ownership and use requirement provided in Section 121(a).

Therefore, we hold that Corporation will recognize no gain or loss on the distribution of the condominiums to tenant-stockholders who utilize their units as their principal residences and that, for purposes of Section 216(e), a tenant-stockholder's unit shall be considered the tenant-stockholder's principal residence so long as the residence satisfies the definition provided in Section 1.121-1(b) without the necessity of also satisfying the two-year ownership and use requirement provided in Section 121(a).

RULING REQUEST # 4

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in Section 1011 for determining gain and the loss is the excess of the adjusted basis provided in Section 1011 for determining loss over the amount realized. Under Section 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 216(e) provides that, except as provided in regulations, no gain or loss shall be recognized on the distribution by a cooperative housing corporation of a dwelling unit to a stockholder in such corporation if such distribution is in exchange for the stockholder's stock in such corporation and such dwelling unit is used as his principal residence (within the meaning of section 121).

The non-recognition provided by Section 216(e) is limited to those circumstances where the dwelling unit being distributed by the cooperative housing corporation is used as the tenant-stockholder's principal residence. Where the dwelling unit distributed is not used as the tenant-stockholder's principal residence, the general rules of Â§ 1001 will apply. Therefore, we hold that Corporation will recognize gain in an amount equal to the amount by which the fair market value of a distributed unit exceeds the adjusted basis of the unit in the hands of Corporation on the distribution of a unit to a tenant-stockholder who does not utilize his unit as a principal residence.

RULING REQUEST # 5

Section 216(b)(1) provides that the term "cooperative housing corporation" means a corporation –

(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

Section 1.216-1(e)(3) provides that none of the stockholders of the corporation may be entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution other than out of earnings and profits of the corporation.

Although Section 216(b)(1)(C) does not specifically qualify the term "any distribution" as any distribution with respect to stock, a mere distribution from creditor to debtor apart from and incidental to the corporation-stockholder relationship is not within the contemplation of the statute, because the language "not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation" clearly contemplates a distribution made with respect to stock. Rev. Rul. 75-547, 1975-2 C.B. 89.

While the term "any distribution" contemplates a distribution made with respect to stock, it does not contemplate a distribution of an apartment in complete redemption of a tenant-stockholder's stock in the cooperative housing corporation. To the extent it is applicable, the complete redemption of a tenant-stockholder's stock in exchange for an apartment is governed by Section 216(e).

Therefore, we hold that Corporation will not be disqualified as a "cooperative housing corporation" within the meaning of Section 216(b)(1) with respect to any distribution of a unit to a tenant-stockholder in exchange for all of the tenant-stockholder's stock in Corporation and the cancellation of the related proprietary lease.

RULING REQUEST # 6

Section 1.216-1(e)(2) provides, in relevant part, that each stockholder of the corporation, whether or not the stockholder qualifies as a tenant-stockholder under section 216(b)(2) and paragraph (f) of this section, must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation.

Revenue Ruling 78-31, 1978-1 C.B. 76, considered a scenario where a cooperative housing corporation owned a portion of an apartment building. Revenue Ruling 78-31 concluded that there is no requirement that a cooperative housing corporation must own an entire apartment building in order to satisfy the provisions of Section 216 (b) (1) (B). It is sufficient that the corporation owns the apartments that its tenant-stockholders are

entitled to occupy. In addition, the fact that the apartments are condominium units does not preclude the cooperative housing corporation from being considered as owning apartments in a building.

Therefore, we hold that Corporation will continue to qualify as a "cooperative housing corporation" within the meaning of Section 216(b)(1) even though, in accordance with the plan of conversion, Corporation will own a number of condominiums rather than the undivided buildings.

RULING REQUEST # 7

Revenue Ruling 85-132 considered the issue of whether the exchange of stock in a cooperative housing corporation for legal title to a condominium unit and an undivided interest in the common elements results in nonrecognition of gain under Section 1034. Revenue Ruling 85-132 concludes that the exchange of the tenant-stockholder's stock in the corporation for legal title to the condominium unit occupied by the tenant-stockholder and an undivided interest in the common elements will qualify as a sale within the meaning of Section 1034(a), and no gain or loss will be recognized to the tenant-stockholder on such sale, subject to the limitations of Section 1034(a) and Section 1.1034-1.

In 1988, Congress enacted Section 216(e) as Section 6282 of the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, with an effective date retroactive to the Tax Reform Act of 1986. Section 216(e) was enacted to provide corporate level relief from the application of Section 336 to the extent Section 1034 had already provided for nonrecognition on the tenant-stockholder level. Section 216(e), as enacted, provided that except as provided in regulations, no gain or loss shall be recognized on the distribution by a cooperative housing corporation of a dwelling unit to a stockholder in such corporation if such distribution is in exchange for the stockholder's stock in such corporation and such exchange qualifies for nonrecognition of gain under Section 1034(f). The Conference Report states that "no gain or loss is recognized to a residential housing cooperative when property that qualifies as a principal residence is distributed to a tenant-stockholder in exchange for the tenant-stockholder's stock, to the extent the exchange qualifies for nonrecognition at the shareholder level under section 1034 of the Code." See H.R. Conf. Rep. No. 100-1104, at 242 (1988).

Section 216(e), as enacted, provided for no gain or loss where the exchange of the tenant-stockholder's stock for the unit qualifies for nonrecognition of gain under Section 1034(f). Under Revenue Ruling 85-132, the conversion is treated as a sale, in which the taxpayer has sold his principal residence in the cooperative housing corporation and immediately bought a condominium for the same price, triggering the rollover of all gain under Section 1034(a) for the tenant-stockholder.

In the Taxpayer Relief Act of 1997, Congress amended Section 121 and repealed Section 1034. In conjunction with the repeal of Section 1034, the Taxpayer Relief Act of 1997 provided a conforming amendment to Section 216(e) to reflect the Section 1034 repeal. The 1997 amendment to Section 216(e) resulted in the current language, which provides that no gain or loss shall be recognized on the distribution by a cooperative housing corporation of a dwelling unit to a stockholder in such corporation if such distribution is in exchange for the stockholder's stock in such corporation and such dwelling unit is used as his principal residence (within the meaning of Section 121). The legislative history to the Taxpayer Relief Act of 1997 provides no explanation of the amendment to Section 216(e).

Revenue Ruling 85-132 established that the conversion of a cooperative housing corporation into condominium ownership is a sale or exchange, subject to the rules of former Section 1034. Section 216(e) was enacted to provide a corporate level complement to the treatment already afforded by Section 1034 on the tenant-stockholder level. When Sectino 1034 was repealed in 1997, Section 216(e) was amended to reflect the substitution of amended Section 121 as the key provision governing the sale of an individual's principal residence. There is no indication in the statute or legislative history to suggest that Congress intended to make any change to Section 216(e) other than the replacement of the reference to Section 1034 with a reference to Section 121. Absent a showing of Congressional intent to broaden the application of Section 216(e) to include tenant-stockholders, Section 216(e) should continue to be interpreted as only addressing the consequences to the cooperative housing corporation on the conversion to condominium ownership. Because the conversion is treated as a sale or exchange, the tax treatment of the tenant-stockholders who use their units as their principal residence is governed by Section 121, to the extent it applies.

Therefore, we hold that, consistent with the treatment of the conversion as a sale or exchange, and subject to the provisions of Section 121, gain or loss shall be recognized by each tenant-stockholder who exchanges their stock in Corporation in exchange for a unit that is used as the tenant-stockholder's principal residence to the extent that the unit's fair market value exceeds the tenant-stockholder's basis in his stock.

Accordingly, each tenant-stockholder may exclude from gross income the gain from the exchange of the stock in Corporation only if the requirements of Section 121 have otherwise been satisfied. In determining whether a tenant-stockholder meets the requirements of Section 121, if Corporation meets all the requirements of Section 216 to be a cooperative housing corporation, the exchange of the tenant-stockholder's stock in Corporation for a condominium unit will qualify as an exchange of the unit the tenant-stockholder is entitled to occupy as a result of holding such stock. Further, the ownership and use tests of Section 121 discussed above will be applied as though the tenant-stockholder owned and used such unit. See Section 121(d)(4).

RULING REQUEST # 8

Section 1012 provides that the basis of property is its cost. The cost is the amount paid for such property in cash or other property. Section 1.1021-1(a) of the regulations. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations. See Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954). Therefore, we hold that the basis in the condominium unit for each tenant-stockholder who exchanges their stock for a condominium unit will equal the fair market value of the shareholder's condominium unit.

RULING REQUEST # 9

Section 1223(1) provides that, in determining the period for which a taxpayer has held property received in an exchange, there shall be included the period for which the taxpayer held the property exchanged if the property has, for the purposes of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as the property exchanged, and the property exchanged at the time of such exchange was a capital asset as defined in Section 1221 or property described in Section 1231.

Because the basis in the acquired condominium unit will not be determined by reference to the basis of the co-op stock, Section 1223(1) is inapplicable. A tenant-stockholder's holding period for the stock will not be tacked on to the shareholder's holding period for the condominium unit. Instead, we hold that the holding period will run from the date that the tenant-stockholder acquires the condominium unit.

RULING REQUEST # 10

Section 216(b)(1)(B) provides that, among other requirements for being considered a cooperative housing corporation, each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation

Section 1.216-1(e)(2) provides, in relevant part, that each stockholder of the corporation, whether or not the stockholder qualifies as a tenant-stockholder under Section 216(b)(2) and paragraph (f) of this section, must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. Such right must be conferred on each stockholder solely by reasons of his or her ownership of stock in the corporation. That is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. A lease between a cooperative housing corporation and a tenant-stockholder is often the mechanism under which a tenant-stockholder takes possession of a unit in the cooperative. However, under Section 216(b)(1)(B), a tenant-stockholder has the right to possess a unit in the building solely due to the ownership of stock in the corporation. The lease between the corporation and a tenant-stockholder functions much like the covenants typical with the direct ownership of residential real property. Therefore, the lease should be viewed as a condition on the tenant-stockholder's ownership of stock in the corporation and not as a separate asset. Any valuation of a unit to be distributed to a tenant-stockholder would necessarily include any conditions on the ownership of that unit.

Therefore, we hold that, for purposes of valuing each unit to be distributed to a tenant-stockholder by Corporation, the proprietary lease encumbering the unit and held by the tenant-stockholder shall be taken into account by Corporation and the tenant-stockholder.

RULING REQUEST # 11

Section 216(b)(1)(D) provides that, a cooperative housing corporation is a corporation 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

Section 118 provides that in the case of a corporation, gross income does not include any contribution to the capital of the corporation.

The requirement in Section 216(b)(1)(D) that eighty percent or more of the gross income of the cooperative housing corporation for the taxable year must be derived from tenant-stockholders contemplates that only items that would be includible in the gross income of the corporation are included in determining whether eighty percent of the gross income is derived from tenant-stockholders. Thus if an item is not considered gross income to the cooperative housing corporation it is not taken into account for purposes of Section 216(b)(1)(D). See Eckstein v. United States, 452 F.2d 1036 (Ct. Cl. 1971). Therefore, we hold that amounts considered to be contributions of capital excluded from income pursuant to Section 118 shall not be considered gross income for purposes of the "80 percent gross income" test set forth in Section 216(b)(1)(D).

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

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Joseph H. Makurath
Senior Technician Reviewer, Branch 7
Office of Associate Chief Counsel
(Passthroughs & Special Industries)
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 9309023

Internal Revenue Service (I.R.S.)
Private Letter Ruling (PLR)
Issue: March 5, 1993
December 3, 1992

Section 671 — Trust Income, Deductions, and Credits Attributable to Grantors and Others As Substantial Owners
Section 1014 — Basis of Property Acquired From a Decedent
Section 2056 — Bequests, etc., to Surviving Spouse (Marital Deduction v. No Marital Deduction)
Section 2056A — Qualified Domestic Trusts (Deductible v. Not Deductible)
Section 2523 — Gift to Spouse (Marital Deduction Allowed v. Not Allowed)

Legend:

Transferor =
Spouse =
Son =
Trust =
Revocable Trust =

Dear ***:

This is in response to your letter of January 27, 1992, in which you requested certain rulings on the federal income, estate, and gift tax consequences of the transaction described below.

On May 17, 1991, Transferor, who is not a United States citizen, established the Trust, an irrevocable inter vivos trust, to which she transferred a one-half interest in her solely-owned residence. Transferor's remaining share in the residence was transferred to a revocable inter vivos trust (Revocable Trust) on July 16, 1991.

During Spouse's life, the trustee of the Trust is to be Transferor. The Trust provides that, during the lifetime of Transferor's husband, Spouse, the trustee is to pay over the entire net income from the Trust to spouse in quarter-annual or more frequent installments. The trustee is also empowered to pay over to Spouse part or all of the principal of the Trust as the trustee deems necessary or desirable for any reason or cause that the trustee deems to be in the best interests of Spouse. Spouse shall have the noncumulative power to withdraw the amount of any transfer to the Trust within 30 days of any transfer. Spouse shall have the right to the use and occupancy of the residence until his death or until he notifies the trustee that he no longer desires to reside in the residence. The trustee has the right to purchase another residence in its absolute discretion. Spouse shall have the right to the use and occupancy of any new residence until his death or until he notifies the trustee that he no longer desires to reside in the new residence. Spouse has the power to require that the trustee convert the residence, or any new residence, into productive property within a reasonable time after notifying the trustee of his exercise of this power. Spouse also has the power to acquire any asset held by the Trust free of trust at any time by substituting other property of equal value.

Upon the death of Spouse, the trustee is to pay over the principal of the Trust, to Son, the issue of Son, or the spouse of Son, as Spouse may, by will, appoint. If Spouse fails to exercise this special power of appointment, upon Spouse's death, if Transferor is living, the principal of the Trust is to be held in further trust (the Trust) for the benefit of Transferor. From that time, Spouse's brother and Transferor's son will serve as co-trustees of the Trust.

Transferor proposes to elect to treat the transfer of the one-half interest in the residence to the Trust for the benefit of Spouse as qualified terminable interest property under section 2523(f) of the Code.

In the event that Transferor survives Spouse, and Spouse fails to exercise his special power of appointment, the trustees of the Trust are to pay the net income of the Trust to Transferor in quarter-annual or more frequent installments. In addition, the trustees may pay to Transferor such principal of the Trust as the trustees deem necessary or advisable. The Trust provides that at least one trustee of the Trust must be an individual citizen of the United States or a domestic corporation. The Trust also provides that no distribution (other than a distribution of income) may be made from the Trust unless a trustee who is an individual citizen of the United States or domestic corporation withholds from such distribution the tax imposed by section 2056A on such distribution. The trustees of the Trust are authorized to amend the provisions of the Trust in order to qualify it as a qualified domestic trust under section 2056A of the Code.

If the residence is held as an asset of the Trust, Transferor has the right to the use and occupancy of the residence until her death. Transferor has the right to direct the trustees to purchase a new residence if she does not desire to reside in the residence. Additionally, Transferor has the power to require the trustees to convert the residence or any new residence into productive property within a reasonable time after notifying them of her exercise of the power requiring them to do so. Upon the death of Transferor, the principal of the Trust is to be paid to Transferor's son, if he is living, or to his issue, in equal shares.

The Revocable Trust provides that during the lifetime of Transferor, the trustees shall pay over the entire net income from the Revocable Trust to Transferor or Spouse. The trustees are also empowered to pay over during Transferor's lifetime part or all of the principal to Transferor or Spouse. Upon the death of Transferor, if Spouse survives, the trustees shall divide the principal into two separate shares, Share A and Share B. Share A will consist of the exemption equivalent of the unified credit and will be held in a trust for the benefit of Spouse. Share B will consist of the remainder of

the trust principal. Share B will also be held for the exclusive benefit of Spouse. The net income of Share B is to be paid to Spouse at least quarter annually. The trustees may, in their absolute discretion, also pay over or apply principal for Spouse's benefit. Upon the death of Spouse, the principal of the Share B trust will be paid over to certain named beneficiaries.

Issue 1

Section 671 of the Internal Revenue Code provides the general rule that, where the grantor or another person is treated as the owner of any portion of a trust, there shall be included in computing his or her taxable income and credits those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credits against the tax of an individual.

Section 673 through 677 of the Code specify the circumstances under which the grantor is regarded as the owner of a portion of a trust.

Section 677(a) of the Code provides, in part, that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor of the grantor's spouse.

Section 678(a) of the Code treats a person other than the grantor as the owner of any portion of a trust with respect to which (1) the person has a power exercisable solely by himself or herself to vest corpus or income therefrom in himself or herself, or (2) the person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would cause a grantor to be treated as the owner of such portion of the trust within the principles of sections 671 to 677, inclusive.

Section 678(b) of the Code provides that section 678(a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of subpart E other than this section.

The power granted to Spouse to withdraw amounts contributed to the Trust will result in Spouse being treated as the owner under section 678(a) of the Code of the portion of the Trust over which he has discretion to require the trustee to distribute said amounts, unless Transferor is treated as the owner under section 678(b).

Under the terms of the Trust, both income and corpus are payable to Spouse during his life. Accordingly, Transferor is treated as the owner of the Trust under section 677(a) of the Code. Because Transferor is treated as the owner of the Trust under section 677(a), Spouse is not the owner of the Trust under section 678(a). See section 678(b). Accordingly, there shall be included in computing the taxable income and credits of Transferor all items of income, deductions and credits against tax of the Trust.

If Transferor survives Spouse, and Spouse fails to exercise his special power of appointment, the trustees of the Trust are to pay the net income of the Trust to Transferor. The trustees may also pay to Transferor such principal of the Trust as the trustees deem necessary or advisable. Under these circumstances, Transferor will be treated as the owner of the Trust because Transferor is entitled to receive the distributions of principal and income of the Trust.

Issue 2 (withdrawn)

Issue 3 Basis

Section 1014(a) of the Code provides that, subject to certain exceptions, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death.

For purposes of section 1014(a), section 1014(b) provides, in relevant part, that the following property shall be considered to have been acquired from or to have passed from the decedent:

(10) Property includible in the gross estate of the decedent under section 2044 (relating to certain property for which a marital deduction was previously allowed).

In the present case, on May 17, 1991, Transferor established Trust and on the same day transferred to the Trust a one-half interest in the residence. Spouse has a qualified income interest for life in the Trust and Transferor intends to make an election under section 2523(f) of the Code to treat the transfer of the residence to the Trust as qualified terminable interest property. Assuming section 2519 does not apply, the Trust property subject to the election under section 2523(f) will be includible in Spouse's estate under section 2044 and will be treated under section 1014(b)(10) as property acquired from or having passed from the decedent. Accordingly, the basis of the Trust property includible in Spouse's estate under section 2044 will be the fair market value of the property at the date of Spouse's death.

Issues 5 and 6 (Since the taxpayer has withdrawn ruling request 12, we are unable to address ruling 14).

Section 121 of the Code provides a one-time exclusion from gross income of gain from the sale or exchange of property if the taxpayer has attained the age of 55 before the date of the sale or exchange and the taxpayer has owned and used the property as the taxpayer's principal residence for 3 of the last 5 years ending on the date of the sale or exchange. The maximum amount of gain that may be excluded under section 121 is limited to $125,000 per taxpayer or married couple.

Section 1034(a) of the Code provides that if property ("old residence") used by the taxpayer as his principal residence is sold by him and, within a period beginning 2 years before the date of such sale and ending 2 years after such date, property ("new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale is recognized only to the extent that the taxpayer's adjusted sales price (as defined in subsection (b)) of the old residence exceeds the taxpayer's cost of purchasing the new residence.

Section 671 of the Code provides that if a grantor or other person is treated as the owner of any portion of a trust, then those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust must be included in computing the taxable income and credits of the grantor or such other person.

Rev. Rul. 66-159, 1966-1 C.B. 162, states that where the grantor is treated as the owner of an entire trust under sections 676 and 671 of the Code, a sale by the trust will be treated as if made by the grantor. If all requirements are satisfied under section 1034, gain is not recognized where the trust sells property used by the grantor as his principal residence and purchases property at a price equal to or in excess of the selling price of the old property and the grantor uses it as her principal residence.

Rev. Rul. 85-45, 1985-1 C.B. 183, states that, if the grantor is treated as the owner of an entire trust, then section 121 of the Code may be utilized if all requirements of that section are met.

Rev. Rul. 84-43, 1984-1 C.B. 27, provides for an exclusion under section 121 of the Code only where the taxpayer sells his or her entire interest in such principal residence.

In the instant case, it has been determined that, during her life, Transferor will be treated as the owner for federal income tax purposes of the ordinary income and corpus interests of both the Trust and the Revocable Trust.

Accordingly, we conclude that, while Transferor is alive, the gain on the sale by the Trust and the Revocable Trust of Transferor's entire interest in the Residence, if used by Transferor as her principal residence, will be eligible for exclusion under section 121(a) of the Code and nonrecognition under section 1034(a) to the same extent as if the interest had been owned by Transferor outright, regardless of whether the interest in the new principal residence is purchased by Transferor, the Trust, the Revocable Trust (or, if the spouses properly elect to have section 1034(g) apply and both the old residence and the new residence are used by Spouse and Transferor as their principal residence, the husband), or by both of them jointly.

Issue 10 Gift Tax

Section 2501 of the Code imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident. Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 2523(a) of the Code provides that, where a donor transfers during the calendar year by gift an interest in property to a donee who at the time of the gift is the donor's spouse, except as limited by section 2523(b), there shall be allowed as a deduction in computing taxable gifts for the calendar year an amount with respect to such interest equal to its value.

Section 2523(b) of the Code provides the general rule that no deduction shall be allowed for an interest transferred to the spouse if, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, the interest will terminate or fail if the donor retains or transfers to any person other than the donee spouse an interest in the transferred property.

Section 2523(f) of the Code provides that, in the case of qualified terminable interest property, for purposes of section 2523(b), no part of the property will be considered as retained by the donor or transferred to any person other than the donee spouse. For purposes of this section qualified terminable interest property is property which is transferred by the donor spouse, in which the donee spouse has a qualifying income interest for life, and to which an election under this section applies. The donee spouse has a qualifying income interest for life if: (1) the donee spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and (2) no person has a power to appoint any part of the property to any person other than the surviving spouse.

In general, the principles in section 25.2523(e)-1(f) of the Gift Tax Regulations, relating to whether the spouse is entitled for life to all the income from the entire interest or a specific portion of the interest, are applicable in determining whether the donee spouse is entitled for life to all of the income from the property, regardless of whether the interest passing to the donee spouse is in trust. Section 25.2523(e)-1(f)(4) provides, in part, that the power of the trustee to retain a residence for the spouse or other property for the personal use of the spouse will not disqualify the interest transferred in trust.

In this case, the trustee of the Trust is required to pay the income of the Trust to Spouse quarter-annually or more frequently. Spouse is entitled to use and occupancy of the residence. Spouse has the power to require the trustees to convert the residence or any new residence into productive property. Thus, Spouse has the right to receive all the income from the Trust for life. In addition, no person has a power to appoint, during Spouse's lifetime, any part of the property to any person other than Spouse. Therefore, Spouse has a qualifying income interest for life in the Trust, and an election under section 2523(f) of the Code may be made with respect to the property transferred by Transferor to the Trust.

Issue 7 Spouse's Estate Tax

Section 2056(a) of the Code provides that, for purposes of the tax imposed by section 2001, the value of the taxable estate is to be determined, except as limited by section 2056(b), by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to his surviving spouse but only to the extent that such property is included in determining the value of the gross estate.

Section 2056(b)(1) of the Code provides the general rule that no deduction shall be allowed for an interest passing to the surviving spouse if, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, the interest will terminate or fail.

Section 2056(b)(7)(A) of the Code provides that, in the case of qualified terminable interest property, the property shall be treated as passing to the surviving spouse for purposes of 2056(a) and no part of the property shall be treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B)(i) of the Code defines "qualified terminable interest property" as property: (1) which passed from the decedent, (2) in which the surviving spouse has a qualifying income interest for life, and (3) to which an election under section 2056(b)(7)(B)(v) applies.

Section 2056(b)(7)(B)(ii) of the Code provides that the surviving spouse will be considered to have a qualifying income interest for life if the surviving spouse is entitled to all of the income from the property payable annually or at more frequent intervals, and no other person has a power to appoint any part of the property to any person other than the surviving spouse.

Section 2056(b)(7)(B)(v) of the Code provides that an election under section 2056(b)(7) with respect to any property shall be made by the executor on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable.

In general, the principles of section 20.2056(b)-5(f) of the Estate Tax Regulations, relating to whether the spouse is entitled for life to all of the income from the entire interest or a specific portion of the interest, are applicable in determining whether the surviving spouse is entitled for life to all the income from the property, regardless of whether the interest passing to the donee spouse is in trust. Section 20.2056(b)-5(f)(4) provides, in part, that the power of the trustee to retain a residence for the spouse or other property for the personal use of the spouse will not disqualify the interest passing in trust.

In the present case, assuming that Transferor survives Spouse and Spouse does not exercise his special power of appointment with respect to the Trust, upon the death of Spouse, Transferor will be entitled to all the income from the Trust, payable at least quarter-annually. Transferor will be entitled to the use and occupancy of the residence until her death. Transferor may direct the trustees to purchase another residence, and she may require the trustees to convert the residence, or any new residence into productive property within a reasonable time. Thus, Transferor has the right to receive all income from the Trust for life. In addition, no person has a power to appoint, during Transferor's lifetime, any part of the property to any person other than Transferor. Therefore, Transferor will have a qualifying income interest for life, and an election under section 2056(b)(7) of the Code is allowable with respect to the property that would, for purposes of section 2044, be treated as passing upon Spouse's death to or for the benefit of Transferor.

Issue 8 Qualified Domestic Trust

Section 2056(d) of the Code provides that, in the case of decedents dying after November 10, 1988, where the surviving spouse is not a United States citizen, the federal estate tax marital deduction is allowed if property passes to or is timely transferred to a qualified domestic trust.

Under section 2056A(a), a qualified domestic trust is defined as any trust if:

(1) the trust instrument-

(A) requires that at least one trustee of the trust be an individual citizen of the United States or domestic corporation, and

(B) no distribution (other than a distribution of income) may be made from the trust unless a trustee who is an individual citizen of the United States or a domestic corporation has the right to withhold from the distribution the tax imposed on the distribution;

(2) the trust meets such requirements as the Secretary may by regulations prescribe to ensure the collection of any tax imposed by section 2056A(b); and

(3) an election by the executor of the decedent applies to the trust.

In the present case the Trust provides that, if the Trust property is to be held, after Spouse's death, in further trust for the benefit of Transferor, that at least one trustee of the Trust must be an individual citizen of the United States or a United States domestic corporation. No distribution (other than a distribution of income) may be made from the Trust unless a trustee who is an individual citizen of the United States or a domestic corporation withholds form such distribution the tax imposed by section 2056A on such distribution. The trustees are authorized to amend the provisions of the Trust in order to qualify it as a qualified domestic trust, as defined in section 2056A, and as the Secretary of the United States Treasury may by regulations prescribe. Additionally, the Trust meets the requirements of section 2056(b)(7) in order to be treated as qualified terminable interest property. Accordingly, assuming that the election under section 2056A(3) is made, Spouse's executor may treat all of the property in the Trust as a qualified domestic trust.

Issues 9 and 22 Transferor's Estate Tax

Section 2523(f)(5)(A) provides that, in the case of any qualified terminable interest property, such property shall not be includible in the gross estate of the donor spouse, and any subsequent transfer by the donor spouse of an interest in such property shall not be treated as a transfer for gift tax purposes.

Section 2523(f)(5)(B) provides that section 2523(f)(5)(A) shall not apply with respect to any property after the donee spouse is treated as having transferred such property under section 2519, or such property is includible in the donee spouse's estate under section 2044.

Section 2044(a) of the Code provides that the value of the gross estate shall include the value of any property to which section 2044 applies in which the decedent had a qualifying income interest for life.

Section 2044(b) provides that section 2044 applies to any property if a deduction was allowed with respect to the transfer of such property to the decedent under section 2056(b)(7) or section 2523(f) and section 2519 did not apply with respect to a disposition by the decedent of part or all of such property.

Section 2044(c) provides that, for purposes of the estate tax chapter and the generation-skipping transfer tax chapter, property includible in the gross estate of the decedent under section 2044(a) shall be treated for purposes of the estate tax chapter of the Code as property passing from the decedent.

In the present case, Transferor proposes to make a qualified terminable interest property election under section 2523(f) with respect to the property transferred to the Trust for the benefit of Spouse. Assuming that section 2519 does not apply, the Trust property will be includible in Spouse's estate under section 2044(a) upon Spouse's death. In the event that Spouse fails to exercise his special testamentary power of appointment over the Trust property, the property passing to the Trust for the benefit of Transferor will be treated under section 2044(c) as passing from Spouse to Transferor. To the extent that Spouse's executor makes a qualified terminable interest property election under section 2056(b)(7) the property in the Trust will be includible in Transferor's estate upon her death, under section 2044. If Spouse's executor does not make an election under section 2056(b)(7) with respect to all of the Trust, Transferor will still be entitled to the income from the Trust. Because this property is treated under section 2044(c) as passing from Spouse to Transferor, however, Transferor cannot be treated as transferor of this property for purposes of section 2036(a). Therefore, if a qualified terminable interest property election is not made with respect to the property in the Trust at the death of Spouse, the property will not be includible in Transferor's estate under either section 2044 or section 2036.

In regard to issue 12, Transferor has transferred property to Trust for which she intends to make a qualified terminable interest property election under section 2523(f) of the Code. Transferor as trustee of the Trust has the power to pay to Spouse at any time and from time to time during Spouse's lifetime, part or all of the principal of the Trust in the trustee's absolute discretion as the trustee deems necessary and advisable for any reason or cause whatever. Under section 2523(f)(5)(A) any subsequent transfer by the donor spouse of an interest in the qualified terminable interest property is not treated as a transfer for gift tax purposes. Accordingly, since Transferor is the donor with respect to the qualified terminable interest property in the Trust, although Transferor has the discretionary power as trustee to distribute principal from the Trust to Spouse, the exercise of this power will not be considered a transfer for gift tax purposes pursuant to section 2523(f)(5)(A).

Issue 11 Spouse's Gift Tax and Estate Tax

Section 2514(b) of the Code provides that the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer that is treated as a gift for federal gift tax purposes.

Section 2514(c) of the Code defines a general power of appointment as a power which is exercisable in favor of the individual possessing the power, his estate, his creditors or the creditors of his estate.

Section 2514(e) of the Code provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of the power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts: (1) $5,000 or (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have.been satisfied.

Section 25.2514-3(c)(1) of the regulations provides that the general principles set forth in section 25.2511-2 for determining whether a donor of property (or of a property right or interest) has divested himself of all or any portion of his interest therein to the extent necessary to effect a completed gift are applicable in determining whether a partial release of a power of appointment constitutes a taxable gift. Thus, if a general power of appointment is partially released so that thereafter the donor may still appoint among a limited class of persons not including himself the partial release does not effect a completed gift since the possessor of the power has retained the right to designate the ultimate beneficiaries of the property over which he holds the power and since it is only the termination of such control which completes a gift.

In the present case, under the terms of the Trust, Spouse has been given a temporary power to withdraw any amount contributed to the Trust within thirty days of such contribution. To the extent such withdrawal right has not been exercised by the end of the thirty day period, the right of withdrawal will lapse. At any time during the term of the Trust if a lapse of Spouse's power of withdrawal occurs, Spouse still possesses the right to the income from the Trust and a testamentary power to appoint the Trust property among Son, Son's issue or Son's spouse. Consequently, although the lapse of the general power of appointment thirty days after any transfer to the Trust is a release for purposes of section 2514, Spouse, through his income interest and testamentary power of appointment, has sufficient interest in and power over the Trust that the lapse of the general power of appointment is not a completed gift for purposes of section 2511. Accordingly, the lapse of Spouse's general power of appointment over any property transferred to the Trust will not be deemed a gift for purposes of section 2514.

Section 2041(a) of the Code provides that the value of a decedent's gross estate includes the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under section 2035 to 2038, inclusive.

Section 2041(b)(1) provides that the term "general power of appointment" means, with certain exceptions, a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power.

Accordingly, we conclude that to the extent Spouse's withdrawal right has not been exercised by the end of the thirty day period following any contribution to the Trust, there will be a lapse of a general power of appointment that is deemed to be a release of such a power under section 2041. The combination of the release with the retention by Spouse of a life income interest and a special testamentary power to appoint the Trust property will result, upon Spouse's death, in an inclusion of the Trust property in Spouse's gross estate under section 2041.

Except as we have specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the ruling. See section 11.04 of Rev. Proc. 92-1, 1992-1 I.R.B. 9, 30 (or its successor). However, when the criteria in section 11.05 of Rev. Proc. 92-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the power of attorney and declaration of representative currently on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special Industries)

Richard Grosgebauer
Chief, Branch 4
This document may not be used or cited as precedent.

PRIVATE LETTER RULING 8942008

Internal Revenue Service (I.R.S.)
Private Letter Ruling
Issue: October 20, 1989
July 17, 1989

Section 121 — One Time Exclusion of Gain from Sale of Principal Residence by Individual Who Has Attained Age 55

LEGEND:

Husband =
Wife =
Mother =
Property =

This is in response to your submission of September 16, 1988. Additional information was received January 9 and February 14, 1989.

Husband and Wife, by the entireties, own Property jointly with Mother. There are two houses on the Property. Husband and Wife have occupied one house from 1983 to the present. It is represented that they have done so as their principal residence. Mother, from 1940 to May, 1987, occupied the other house. It is represented that this was her principal residence during this period. In May of 1987, Mother voluntarily entered a home for the elderly, one licensed by the State of * * * as a facility for those physically or mentally unable to care for themselves. Husband, Wife and Mother are all over age 55. Husband, Wife and Mother now wish to sell the Property, including the houses, and exclude any gain under section 121 of the Internal Revenue Code of 1986.

Section 121 allows an individual to exclude any gain, up to $125,000, on the sale of property from gross income if certain conditions are met: First, the taxpayer must have attained the age of 55. Second, the taxpayer, during the five-year period ending on the date of the sale or exchange, must have used the property as his principal residence for three of those five years. If the conditions are met, the taxpayer may elect to exclude up to $125,000 of gain on the sale of the property from gross income. In section 6011(a) of the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, Congress amended section 121 to allow taxpayers who have become physically or mentally incapable of self-care and who have entered a state-licensed facility for the care of mentally or physically disabled individuals to continue to qualify for the benefits of section 121 if they owned and used the property as their principal residence for at least one year of the five-year period referred to above.

Section 121 is available to joint owners of property otherwise qualifying for the benefits of section 121. In Revenue Ruling 67-234, 1967-2 C.B. 78, the Service ruled that an unmarried individual who held title to his principal residence as a joint tenant or tenant-in-common could exclude from his gross income under section 121 that portion of the gain which was attributable to his undivided interest in the residence at the time of the sale. In Revenue Ruling 67-235, 1967-2 C.B. 79, the Service held that a brother and sister who jointly owned their principal residence could utilize section 121 to exclude from gross income the portion of the gain on the sale of the residence attributable to their undivided interests. Thus, section 121 is available to joint owners of property who are not married. Further, the gain each joint owner may exclude from income is limited to that portion attributable to their undivided interest in the residence.

Based on the facts as represented, we rule that Husband and Wife, as one joint owner, and Mother, as the other joint owner, may each exclude their share of the gain on the sale of Property, up to $125,000, attributable to their undivided interest in the Property, but only to the extent used by each joint owner as their principle residence. We make no determination as to which portion of the Property is to be considered the principle residence of the taxpayers.

This ruling is premised on the assumption that each of Husband, Wife and Mother occupied Property as their principal residence.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. A copy of this ruling should be attached to the return of each taxpayer.

Sincerely yours,

Assistant Chief Counsel
(Income Tax and Accounting)
By: William A. Galanko
Chief, Branch 6

GENERAL COUNSEL MEMORANDUM 38188

December 3, 1979

Memorandum to:

RUSSEL E. DYKE

Assistant Commissioner (Planning and Research)

Attention: Director, Research and Operations Analysis Division

In a memorandum dated April 12, 1979 the Director, Research and Operations Analysis Division (PR:O) requested the Legislation and Regulations Division (CC:LR) review three hypothetical situations under the new I.R.C. § 121 regulations. A fourth hypothetical situation was added to the request in a memorandum dated September 6, 1979. In a phone conversation on October 23, 1979 Mary Downing of the Research and Operations Analysis Division requested our consideration of two additional hypotheticals. Since the new regulations under section 121 were published on April 27, 1979, the Director, Legislation and Regulations Division (CC:LR) in a memorandum dated October 9, 1979 to the Director, Interpretative Division (CC:I) suggested Interpretative was the appropriate division for responding to the requests. The following will depict the six hypothetical situations and their resolutions under current law.

ANALYSIS

Situation (1): A principal residence is solely owned by husband A. The residence is sold and taxpayer A files a separate return and claims the election. Wife B subsequently divorces A and marries C. Would A or C be entitled to make the election on a future sale? Would C be entitled to make the election in the event B dies or divorces C?

Initially we will assume that A, and all taxpayers making sales in the first four situations, have met the age, holding and use requirements set out in I.R.C. § 121(a). The exclusion of gain under section 121 must be elected by the taxpayer through section 121(c). Treas. Reg. § 1.121-4(a) requires the spouse of a taxpayer who is married at the time of the sale to join in the election. Thus in situation (1), B must join A in the election for it to be valid. The divorce of A by B subsequent to the sale does not affect the election. Under section 121(d)(6)(a) and Treas. Reg. § 1 .121-5(f) the taxpayer's marital status is determined at the time of the sale. At the time of sale A and B were married and any election made is binding upon both A and B for life, unless subsequently revoked by both of them. Treas. Reg. § 1.121-2(b)(1)(ii). Thus, in situation (1) both A and B will be treated as having made the lifetime election. The legislative history makes it clear the election is binding subsequent to a divorce by stating: "If spouses make an election during marriage, and subsequently become divorced, no further elections are available to either of them or to their spouses should they [re]marry " H. Rep. No. 95-1445, 95th Cong., 2d Sess. 136 (August 4, 1978).

The marriage between B and C will bar C from electing section 121 nonrecognition on a future sale by C. The previous election of B is to be considered without regard to whether C was married to B at the time of the previous election. Treas. Reg. § 121-2(b)(1)(ii). Example (1) of Treas. Reg . § 1.121-2(b)(2) demonstrates the operation of section 121 to situation (1):

While A and B are married, A sells his separately owned residence and makes an election under section 121(a) in respect of such sale. Pursuant to the requirement of section 121(c), B joins in such election. Subsequently, A and B are divorced and B married C. While B and C are married, C sells his residence. C is not entitled to make an election under section 121(a) since an election by B, his spouse, is in effect. It does not matter that B obtained no personal benefit from her election.

We have established that the time to determine if B has an election in effect is at the time of sale by C. Treas. Reg. § 1 .121-2(b)(1)(ii). Therefore in the event B was to die or divorce C, as long as B was married to C on the day of the sale, then C is barred from the section 121 exclusion on that sale.

Situation (2): A and B are married taxpayers who make the $100,000 election. A and B divorce. C , a single taxpayer sells his residence in January, 1980. In May of 1980, C marries B. Is C allowed to make the election on his tax year 1980 return? Does it make any difference whether C filed a married separate or a joint 1980 return?

As stated in situation (1) the election is binding on both spouses even subsequent to a divorce. Since the time to determine what elections may be in effect is the time of sale, C was single when he sold the residence and may thus elect section 121 without being barred by B's election. Example (3) of Treas. Reg . § 1.121-2(b)(2) covers our situation exactly by providing:

The facts are the same as in example (1)[1] except that C marries B after C sells his residence but before he makes an election under section 121(a) with respect to any gain realized on such sale. C, if there is not in effect an election made by him under section 121(a) with respect to a prior sale, may make an election with respect to his sale since B does not have to join with him in such election.

As the example indicates C may take the election on his 1980 return. Although it should not make a difference whether C files separately or jointly with B, section 121 imposes different excludable amounts. Section 121(b)(1) provides "[t]he amount of the gain excluded from gross income under subsection (a) shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual) " Thus if C files jointly with B they may exclude $100,000, but if C files separately he may only exclude $50,000.

The legislative history is void of any explanation for the separate $50,000 exclusion. The $50,000 limit for married filing separately was inserted by the House Ways and Means Committee in its consideration of § 404 of The Revenue Act of 1978 P.L. 95-600, and was enacted without comment.

Although the extra limit does not seem to produce consistent treatment, we are bound by the literal reading of the statute and must therefore adhere to the $50,000 limit for married filing separately taxpayers.

The $50,000 limit only makes sense when applied to joint ownership where each spouse will report one-half of the gain on each separate return and each spouse will be entitled to one-half of the total exclusion. As situation (2) demonstrates, when the $50,000 limit is applied to C who solely owns a residence and subsequently marries, when C files a "married filing separately" return he would report $100,000 of gain on his separate return but be arbitrarily limited to a $50,000 exclusion instead of the $100,000 exclusion. Since there seems to be no sound basis to limit C to a $50,000 exclusion, we do not believe Congress was aware of this arbitrary result when they inserted the $50,000 limit in section 121. We therefore suggest that the appropriate division of the Office of the Assistant Commissioner (Planning and Research) initiate corrective legislation to retroactively remove or clarify the $50,000 exclusion limit for "married filing separately" under section 121.

Situation (3): A and B are two single taxpayers, who sold their respective residences in August 1978. Each had a gain of $100,000 for a total gain of $200,000. In September of 1978, A married B. If they file a joint return for 1978, what is the total amount of exclusion they are entitled to? What is the total amount allowed if they file separate returns?

Treas. Reg. § 1.121-2(b)(1)(ii) outlines a circumstance where two taxpayers each own a residence, marry, and subsequently sell each residence. The taxpayer's are allowed to elect the section 121 exclusion for only one of the residences since they were married at the time of sale.

Situation (3) is not explicitly covered by the regulations, but since the taxpayers were single at the critical sale date they are each entitled to a $100,000 exclusion. That this result was intended is implied by the following statement in the committee report:

If, however, each of two parties have made elections independently prior to becoming married, there is to be no recapture of the taxes attributable to the gain excluded with respect to the sale of one of the residences. H. Rep. No. 95-1445, 95th Cong., 2d Sess. 135 (August 4, 1978).

However, the result of A and B each being entitled to a $100,000 exclusion is apparently only available if the taxpayers file a joint return. Under section 121(b)(1) if the taxpayers file "married filing separately" they would be limited to a $50,000 exclusion each.

Situation (4): January, 1980; A and B are married and own a home. February, 1980; A and B divorce. November, 1980; A and C marry. December, 1980; A and B sell the home. Would A and B, as unmarried co-owners each be entitled to exclude $100,000 of the gain? May one co-owner use the exclusion while the other chooses not to? Will C be considered to have taken the life-time election?

The regulations do not explicitly cover unmarried co-owners as a separate category, therefore each individual is to be treated as a separate taxpayer. Rev. Rul. 67-234 provides as follows:

An unmarried individual holds title to his residence as a joint tenant or tenant in common. He meets all the age, use, and holding requirements of section 121 of the Internal Revenue Code of 1954, relating to the exclusion from gross income of gain from the sale or exchange of a residence of an individual who has attained the age of 65. Held , such taxpayer is entitled to exclude from gross income, subject to the limitations of section 121 of the Code, that portion of the gain which is attributable to his undivided interest in the residence at the time of the sale. Rev. Rul. 67-234, 67-2 C.B. 78, 79. See also, Rev. Rul. 67-235, 67-2 C.B. 79, for apportioning with regards to a brother and sister jointly owned residence.

We therefore believe the gain on the sale by unmarried co-owners must be apportioned based upon the undivided interest attributable to each A and B. The co-owners may thereby elect to exclude their attributable share up to the $100,000 limit. Because A and B are separate taxpayers A may elect while B does not; and vice versa.
If C sold a residence, while married to A, C is prevented from electing the section 121 exclusion since C would have been required to join in A's election when A sold the jointly owned property. Therefore, C is considered to have taken the lifetime election by joining in A's election upon A 's sale as a co-owner.
Situation (5): Husband and wife jointly own property and file married filing separate returns. To qualify for the section 121 exclusion are both spouses required to satisfy the age, holding and use requirements of section 121(a)?

A spouse of a taxpayer who satisfies the age, holding and use requirements will be deemed to satisfy the same requirements if they qualify under section 121(d)(1) and Treas. Reg. § 1.121-5(a). Section 121(d)(1)(B) explicitly requires that a "joint return" be filed in order to treat the spouse of a person who meets all the requirements, as meeting the same requirements. Since in situation (5) the spouses file married filing separately, then the taxpayers do not meet the section 121(d)(1)(B) joint return requirement and thus both spouses must individually meet the age, holding and use requirements. By filing married filing separately each spouse is limited to a $50,000 exclusion under section 121(b)(1).

Situation (6): If one spouse separately owns property, does that spouse alone have to meet the age, holding and use requirements or do both spouses have to satisfy the requirements? Does it matter if the taxpayers file jointly or separately?

Since one spouse owns the property separately, section 121(d)(1)(A) does not apply as it does in the case of joint ownership. However, assuming the taxpayer's spouse joins in the election, there is nothing to prevent the taxpayer from selling the separately owned property and electing the section 121 exclusion, as long as the taxpayer individually satisfies the age, holding and use requirements. Therefore only the spouse who owns the property is required to satisfy the age, holding and use requirements. The type of return will not affect eligibility to exclude, rather it will only affect the amount of the exclusion under section 121(b)(1).

N. JEROLD COHEN
Chief Counsel

SUSAN J. HOTINE
Reviewer
Branch No. 1
Interpretative Division

[1]

See example (1) supra at 2.

SECTION 453 INSTALLMENT SALE REGULATIONS

Sec. 1.453-4

Sale of real property involving deferred periodic payments.

(a) In general. Sales of real property involving deferred payments include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) Classes of sales. Such sales, under either paragraph (a) (1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of real property which may be accounted for on the installment method, that is, sales of real property in which (i) there are no payments during the taxable year of the sale or (ii) the payments in such taxable year (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price, or

(2) Deferred-payment sales of real property in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

(c) Determination of ``selling price''. In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the ``selling price''; and for the purpose of determining the payments and the total contract price as those terms are used in section 453, and Sec. Sec. 1.453-1 through 1.453-7, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property. The term ``payments'' does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments, the total contract price, or the selling price.

Sec. 1.453-5

Sale of real property treated on installment method.

(a) In general. In any transaction described in paragraph (b)(1) of Sec. 1.453-4, that is, sales of real property in which there are no payments during the year of sale or the payments in that year do not exceed 30 percent of the selling price, the vendor may return as income from each such transaction in any taxable year that proportion of the installment payments actually received in that year which the gross profit (as described in paragraph (b) of Sec. 1.453-1) realized or to be realized when the property is paid for bears to the total contract price. In any case, the sale of each lot or parcel of a subdivided tract must be treated as a separate transaction and gain or loss computed accordingly. (See paragraph (a) of Sec. 1.61-6.)

(b) Defaults and repossessions—

(1) Effective date. This paragraph shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and Sec. Sec. 1.1038-1 through 1.1038-3.

(2) Gain or loss on reacquisition of property. If the purchaser of real property on the installment plan defaults in any of his payments, and the vendor returning income on the installment method reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of reacquisition of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition.

(3) Fair market value of reacquired property. If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary.

(4) Basis of obligations. The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453(d)(2) and paragraph (b)(2) of Sec. 1.453-9.

(5) Bad debt deduction. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction

exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. See section 166 and the regulations thereunder.

(6) Basis of reacquired property. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of any fixed improvements placed on the property by the purchaser.

Sec. 1.453-6

Deferred payment sale of real property not on installment method.

(a) Value of obligations.

(1) In transactions included in paragraph (b)(2) of Sec. 1.453-4, that is, sales of real property involving deferred payments in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. Such obligations, however, are not considered in determining whether the payments during the year of sale exceed 30 percent of the selling price.

(2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

(b) Repossession of property where title is retained by vendor—

(1) Gain or loss on repossession. If the vendor in sales referred to in paragraph (a) of this section has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between—

(i) The entire amount of the payments actually received on thecontract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, and

(ii) The sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed.

(2) Basis of repossessed property. The basis of the property described in subparagraph (1) of this paragraph in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, except that, with respect to repossessions occurring after September 18, 1958, the basis of the property shall be reduced by what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser if the sale had not been made.

(c) Reacquisition of property where title is transferred to purchaser—

(1) Gain or loss on reacquisition. If the vendor in sales described in paragraph (a) of this section has previously transferred title to the purchaser, and the purchaser defaults in any of his payments, and the vendor accepts a voluntary reconveyance of the property, in partial or full satisfaction of the unpaid portion of the purchase price, the receipt of the property so reacquired, to the extent of its fair market value at that time, including the fair market value of fixed improvements placed on the property by the purchaser, shall be considered as the receipt of payment on the obligations satisfied. If the fair market value of the property is greater than the basis of the obligations of the purchaser so satisfied (generally, such basis being the fair market value of such obligations previously recognized in computing income), the excess constitutes ordinary income. If the value of such property is less than the basis of such obligations, the difference may be deducted as a bad debt if uncollectible, except that, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain or loss resulting from the transaction is a capital gain or loss subject to the provisions of sections 1201 through 1241.

(2) Basis of reacquired property. If the reacquired property described in subparagraph (1) of this paragraph is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of the fixed improvements placed on the property by the purchaser. See section 166 and the regulations thereunder with respect to property reacquired by the vendor in a foreclosure proceeding.

(d) Effective date. Paragraphs (b) and (c) of this section shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and Sec. Sec. 1.1038-1 through 1.1038-3.

Sec. 1.453-9
Gain or loss on disposition of installment obligations.

(a) In general. Subject to the exceptions contained in section 453(d)(4) and paragraph (c) of this section, the entire amount of gain or loss resulting from any disposition or satisfaction of installment obligations, computed in accordance with section 453(d), is recognized in the taxable year of such disposition or satisfaction and shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received by the taxpayer.

(b) Computation of gain or loss.

(1) The amount of gain or loss resulting under paragraph (a) of this section is the difference between the basis of the obligation and (i) the amount realized, in the case of satisfaction at other than face value or in the case of a sale or exchange, or (ii) the fair market value of the obligation at the time of disposition, if such disposition is other than by sale or exchange.

(2) The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). In 1960 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1948 at a cost of $10,000. During 1960 the company received $5,000 cash and vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1962, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1962 is $5,500, computed as follows:

Proceeds of sale of notes.....	$13,000
Selling price of property.....	$20,000
Cost of property.....	10,000
Total profit.....	10,000
Total contract price.....	20,000

Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.

Face value of notes.....	15,000
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000.....	7,500
Basis of obligation--excess of face value of notes over amount of income returnable were the notes satisfied in full.....	7,500
Taxable income to be reported for 1962.....	5,500

Example (2). Suppose in example (1) the M Corporation, instead of selling the notes, distributed them in 1962 to its shareholders as a dividend, and at the time of such distribution, the fair market value of the notes was $14,000. The income to be reported for 1962 is $6,500, computed as follows:

Fair market value of notes.....	$14,000
Basis of obligation--excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in example (1)).....	7,500
Taxable income to be reported for 1962.....	6,500

(c) Disposition from which no gain or loss is recognized. (1)

(i) Under section 453(d)(4)(A), no gain or loss shall be recognized to a distributing corporation with respect to the distribution made after November 13, 1966, of installment obligations if (a) the distribution is made pursuant to a plan for the complete liquidation of a subsidiary under section 332, and (b) the basis of the such obligations in the hands of the distributee is determined under section 334(b)(1).

(ii) Under section 453(d)(4)(B), no gain or loss shall be recognized to a distributing corporation with respect to the distribution of installment obligations if the distribution is made, pursuant to a plan for the complete liquidation of a corporation which meets the requirements of section 337, under conditions whereby no gain or loss would have been recognized to the corporation had such installment obligations been sold or exchanged on the day of the distribution. The preceding sentence shall not apply to the extent that under section 453(d)(1) gain to the distributing corporation would be considered as gain to which section 341(f)(2), 617(d)(1), 1245(a)(1), 1250(a)(1),

1251(c)(1), 1252(a)(1), or 1254(a)(1) applies, computed under the principles of the regulations under such provisions. See paragraph (d) of Sec. 1.1245-6, paragraph (c)(6) of Sec. 1.1250-1, paragraph (e)(6) of Sec. 1.1251-1, paragraph (d)(3) of Sec. 1.1252-1, and paragraph (d) of Sec. 1.1254-1.

(2) Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751).

(3) Any amount received by a person in payment or settlement of an installment obligation acquired in a transaction described in subparagraphs (1) or (2) of this paragraph (other than an amount received by a stockholder with respect to an installment obligation distributed to him pursuant to section 337) shall be considered to have the character it would have had in the hands of the person from whom such installment obligation was acquired.

(d) Carryover of installment method. For the treatment of income derived from installment obligations received in transactions to which section 381 (a) is applicable, see section 381(c)(8) and the regulations thereunder.

(e) Installment obligations transmitted at death. Where installment obligations are transmitted at death, see section 691(a)(4) and the regulations thereunder for the treatment of amounts considered income in respect of a decedent.

(f) Losses. See subchapter P (section 1201 and following), chapter 1 of the Code, as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

(g) Disposition of installment obligations to life insurance companies.

(1) Notwithstanding the provisions of section 453(d)(4) and paragraph (c) of this section or any provision of subtitle A relating to the nonrecognition of gain, the entire amount of any gain realized on the disposition of an installment obligation by any person, other than a life insurance company (as defined in section 801(a) and paragraph (b) of Sec. 1.801-3), to a life insurance company or to a partnership of which a life insurance company is a partner shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. If a corporation which is a life insurance company for the taxable year was a corporation which was not a life insurance company for the preceding taxable year, such corporation shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance company, on the last day of the preceding taxable year, all installment obligations which it held on such last day. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. Similarly, a partnership of which a life insurance company becomes a partner shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance company, on the last day of the preceding taxable year of such partnership, all installment obligations which it holds at the time such life insurance company becomes a partner. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section.

(2) The provisions of section 453(d)(5) and subparagraph (1) of this paragraph shall not apply to losses sustained in connection with the disposition of installment obligations to a life insurance company.

(3) For the effective date of the provisions of section 453(d)(5) and this paragraph, see paragraph (f) of Sec. 1.453-10.

(4) Application of the provisions of this paragraph may be illustrated by the following examples:

Example (1). A, an individual, in a transaction to which section 351 applies, transfers in 1961 certain assets, including installment obligations, to a new corporation, X, which qualifies as a life insurance company (as defined in section 801(a)) for the year 1961. A makes his return on the calendar year basis. Section 453(d)(5) provides that the nonrecognition provisions of section 351 will not apply to the installment obligations transferred by A to X Corporation. Therefore, the entire amount of any gain realized by A on the transfer of the installment obligations shall be recognized in 1961, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (2). The M Corporation did not qualify as a life insurance company (as defined in section 801(a)) for the taxable year 1958. On December 31, 1958, it held $60,000 of installment obligations. The M Corporation qualified as a life insurance company for the taxable year 1959. Accordingly, the M Corporation is treated as having transferred to a life insurance company, on December 31, 1958, the $60,000 of installment obligations it held on such date. The gain, if any, realized by M by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (3). During its taxable year 1958, none of the partners of the N partnership qualified as a life insurance company (as defined in section 801(a)). The N partnership held $30,000 of installment obligations on December 31, 1958. On July 30, 1959, the O Corporation, a life insurance company (as defined in section 801(a)), became a partner in the partnership. The N partnership held $50,000 of installment obligations on July 30, 1959. Pursuant to section 453(d)(5), the N partnership is treated as having transferred to a life insurance company, on December 31, 1958, the $50,000 of installment obligations it held on July 30, 1959. The gain, if any, realized by the N partnership by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (4). In 1960, the P Corporation, in a reorganization qualifying under section 368(a), transferred certain assets (including installment obligations) to the R Corporation, a life insurance company as defined in section 801(a). P realized a loss upon the transfer of the installment obligations, which was not recognized under section 361.

Pursuant to subparagraph (2) of paragraph (c) of this section, no loss with respect to the transfer of these obligations will be recognized to P under section 453(d)(1).

Sec. 1.453-12

Allocation of unrecaptured section 1250 gain reported on the installment method.

(a) General rule. Unrecaptured section 1250 gain, as defined in section 1(h)(7), is reported on the installment method if that method otherwise applies under section 453 or 453A and the corresponding regulations. If gain from an installment sale includes unrecaptured section 1250 gain and adjusted net capital gain (as defined in section 1(h)(4)), the unrecaptured section 1250 gain is taken into account before the adjusted net capital gain.

(b) Installment payments from sales before May 7, 1997. The amount of unrecaptured section 1250 gain in an installment payment that is properly taken into account after May 6, 1997, from a sale before May 7, 1997, is determined as if, for all payments properly taken into account after the date of sale but before May 7, 1997, unrecaptured section 1250 gain had been taken into account before adjusted net capital gain.

(c) Installment payments received after May 6, 1997, and on or before August 23, 1999. If the amount of unrecaptured section 1250 gain in an installment payment that is properly taken into account after May 6, 1997, and on or before August 23, 1999, is less than the amount that would have been taken into account under this section, the lesser amount is used to determine the amount of unrecaptured section 1250 gain that remains to be taken into account.

(d) Examples. In each example, the taxpayer, an individual whose taxable year is the calendar year, does not elect out of the installment method. The installment obligation bears adequate stated interest, and the property sold is real property held in a trade or business that qualifies as both section 1231 property and section 1250 property. In all taxable years, the taxpayer's marginal tax rate on ordinary income is 28 percent. The following examples illustrate the rules of this section:

Example 1. General rule. This example illustrates the rule of paragraph (a) of this section as follows:

(i) In 1999, A sells property for $10,000, to be paid in ten equal annual installments beginning on December 1, 1999. A originally purchased the property for $5000, held the property for several years, and took straight-line depreciation deductions in the amount of $3000. In each of the years 1999-2008, A has no other capital or section 1231 gains or losses.

(ii) A's adjusted basis at the time of the sale is $2000. Of A's $8000 of section 1231 gain on the sale of the property, $3000 is attributable to prior straight-line depreciation deductions and is unrecaptured section 1250 gain. The gain on each installment payment is $800.

(iii) As illustrated in the table in this paragraph (iii) of this Example 1., A takes into account the unrecaptured section 1250 gain first. Therefore, the gain on A's first three payments, received in 1999, 2000, and 2001, is taxed at 25 percent. Of the $800 of gain on the fourth payment, received in 2002, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1999	2000	2001	2002	2003	2004-2008	Total gain
Installement gain	800	800	800	800	800	4000	8000
Taxed at 25%	800	800	800	600	-	-	3000
Taxed at 20%	-	-	-	200	800	4000	5000
Remaining to be taxed at 25%	2200	1400	600	-	-	-	-

Example 2. Installment payments from sales prior to May 7, 1997. This example illustrates the rule of paragraph (b) of this section as follows:

(i) The facts are the same as in Example 1 except that A sold the property in 1994, received the first of the ten annual installment payments on December 1, 1994, and had no other capital or section 1231 gains or losses in the years 1994-2003.

(ii) As in Example 1, of A's $8000 of gain on the sale of the property, $3000 was attributable to prior straight-line depreciation deductions and is unrecaptured section 1250 gain.

(iii) As illustrated in the following table, A's first three payments, in 1994, 1995, and 1996, were received before May 7, 1997, and taxed at 28 percent. Under the rule described in paragraph (b) of this section, A determines the allocation of unrecaptured section 1250 gain for each installment payment after May 6, 1997, by taking unrecaptured section 1250 gain into account first, treating the general rule of paragraph (a) of this section as having applied since the time the property was sold, in 1994. Consequently, of the $800 of gain on the fourth payment, received in 1997, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1994	1995	1996	1997	1998	1999-2003	Total gain
Installement gain	800	800	800	800	800	4000	8000
Taxed at 28%	800	800	800	-	-	-	2400
Taxed at 25%	-	-	-	600	-	-	600
Taxed at 20%	-	-	-	200	800	4000	5000
Remaining to be taxed at 25%	2200	1400	600	-	-	-	-

Example 3. Effect of section 1231(c) recapture. This example illustrates the rule of paragraph (a) of this section when there are non-recaptured net section 1231 losses, as defined in section 1231(c)(2), from prior years as follows:

(i) The facts are the same as in Example 1, except that in 1999 A has non-recaptured net section 1231 losses from the previous four years of $1000.

(ii) As illustrated in the table in paragraph (iv) of this Example 3, in 1999, all of A's $800 installment gain is recaptured as ordinary income under section 1231(c). Under the rule described in paragraph (a) of this section, for purposes of determining the amount of unrecaptured section 1250 gain remaining to be taken into account, the $800 recaptured as ordinary income under section 1231(c) is treated as reducing unrecaptured section 1250 gain, rather than adjusted net capital gain. Therefore, A has $2200 of unrecaptured section 1250 gain remaining to be taken into account.

(iii) In the year 2000, A's installment gain is taxed at two rates.

First, $200 is recaptured as ordinary income under section 1231(c).

Second, the remaining $600 of gain on A's year 2000 installment payment is taxed at 25 percent. Because the full $800 of gain reduces unrecaptured section 1250 gain, A has $1400 of unrecaptured section 1250 gain remaining to be taken into account.

(iv) The gain on A's installment payment received in 2001 is taxed at 25 percent. Of the $800 of gain on the fourth payment, received in 2002, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent. The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1999	2000	2001	2002	2003	2004-2008	Total gain
Installement gain	800	800	800	800	800	4000	8000
Taxed at ordinary rates under section 1231(c)	800	200	-	-	-	-	1000
Taxed at 25%	-	600	800	600	-	-	2000
Taxed at 20%	-	-	-	200	800	4000	5000
Remaining non-recapture net §1231 losses	200	-	-	-	-	-	-
Remaining to be taxed at 25%	2200	1400	600	-	-	-	-

Example 4. Effect of a net section 1231 loss. This example illustrates the application of paragraph (a) of this section when there is a net section 1231 loss as follows:

(i) The facts are the same as in Example 1 except that A has section 1231 losses of $1000 in 1999.

(ii) In 1999, A's section 1231 installment gain of $800 does not exceed A's section 1231 losses of $1000. Therefore, A has a net section 1231 loss of $200. As a result, under section 1231(a) all of A's section 1231 gains and losses are treated as ordinary gains and losses. As illustrated in the following table, A's entire $800 of installment gain is ordinary gain. Under the rule described in paragraph (a) of this section, for purposes of determining the amount of unrecaptured section 1250 gain remaining to be taken into account, A's $800 of ordinary section 1231 installment gain in 1999 is treated as reducing unrecaptured section 1250 gain. Therefore, A has $2200 of unrecaptured section 1250 gain remaining to be taken into account.

(iii) In the year 2000, A has $800 of section 1231 installment gain, resulting in a net section 1231 gain of $800. A also has $200 of non-recaptured net section 1231 losses. The $800 gain is taxed at two rates.

First, $200 is taxed at ordinary rates under section 1231(c), recapturing the $200 net section 1231 loss sustained in 1999. Second, the remaining $600 of gain on A's year 2000 installment payment is taxed at 25 percent. As in Example 3, the $200 of section 1231(c) gain is treated as reducing unrecaptured section 1250 gain, rather than adjusted net capital gain. Therefore, A has $1400 of unrecaptured section 1250 gain remaining to be taken into account.

(iv) The gain on A's installment payment received in 2001 is taxed at 25 percent, reducing the remaining unrecaptured section 1250 gain to $600. Of the $800 of gain on the fourth payment, received in 2002, $600 is taxed at 25 percent and the remaining $200 is taxed at 20 percent.

The gain on A's remaining six installment payments is taxed at 20 percent. The table is as follows:

	1999	2000	2001	2002	2003	2004-2008	Total gain
Installement gain	800	800	800	800	800	4000	8000
Ordinary gain under section 1231(a)	800	-	-	-	-	-	800
Taxed at ordinary rates under section 1231(c)	-	200	-	-	-	-	200
Taxed at 25%	-	600	800	600	-	-	2000
Taxed at 20%	-	-	-	200	800	4000	5000
Net section 1231 loss	200	-	-	-	-	-	-
Remaining to be taxed at 25%	2200	1400	600	-	-	-	-

(e) Effective date. This section applies to installment payments properly taken into account after August 23, 1999.

Sec. 1.453A-1
Installment method of reporting income by dealers on personal property.

(a) In general. A dealer (as defined in paragraph (c)(1) of this section) may elect to return the income from the sale of personal property on the installment method if such sale is a sale on the installment plan (as defined in paragraphs (c)(3) and (d) of this section). Under the installment method of accounting, a taxpayer may return as income from installment sales in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when the property is paid for bears to the total contract price. For this purpose, gross profit means sales less cost of goods sold. See paragraph (d) of this section for additional rules relating to the computation of income under the installment method of accounting. In addition, see Sec. 1.453A-2 for rules treating revolving credit plans as installment plans for taxable years beginning on or before December 31, 1986.

(b) Effect of security. A dealer may adopt (but is not required to do so) one of the following four ways of protecting against loss in case of default by the purchaser:

(1) An agreement that title is to remain in the vendor until performance of the purchaser's part of the transaction is completed;

(2) A form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(3) A present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(4) A conveyance to a trustee pending performance of the contract and subject to its provisions.

(c) Definitions of dealer, sale, and sale on the installment plan.

For purposes of the regulations under section 453A--

(1) The term ``dealer'' means a person who regularly sells or otherwise disposes of personal property on the installment plan;

(2) The term ``sale'' includes sales and other dispositions; and

(3) Except as provided in paragraph (d)(2) of this section, the term ``sale on the installment plan'' means--

(i) A sale of personal property by the taxpayer under any plan for the sale of personal property, which plan, by its terms and conditions, contemplates that each sale under the plan will be paid for in two or more payments; or

(ii) A sale of personal property by the taxpayer under any plan for the sale of personal property--

(A) Which plan, by its terms and conditions, contemplates that such sale will be paid for in two or more payments; and

(B) Which sale is in fact paid for in two or more payments.

(d) Installment plans—

(1) Traditional installment plans. A traditional installment plan usually has the following characteristics:

(i) The execution of a separate installment contract for each sale or disposition of personal property; and

(ii) The retention by the dealer of some type of security interest in such property.

Normally, a sale under a traditional installment plan meets the requirements of paragraph (c)(3)(i) of this section.

(2) Revolving credit plans. Sales under a revolving credit plan (within the meaning of Sec. 1.453A-2(c)(1))--

(i) Are treated, for taxable years beginning on or before December 31, 1986, as sales on the installment plan to the extent provided in Sec. 1.453A-2, which provides for the application of the requirements of paragraph (c)(3)(ii) of this section to sales under revolving credit plans; and

(ii) Are not treated as sales on the installment plan for taxable years beginning after December 31, 1986.

(e) Installment income of dealers in personal property—

(1) In general. The income from sales on the installment plan of a dealer may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which the gross profit realized or to be realized on the total sales on the installment plan made during each year bears to the total contract price of all such sales made during that respective year. However, if the dealer demonstrates to the satisfaction of the district director that income from sales on the installment plan is clearly reflected, the income from such sales may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which either:

(i) The gross profit realized or to be realized on the total credit sales made during each year bears to the total contract price of all credit sales during that respective year, or

(ii) The gross profit realized or to be realized on all sales made during each year bears to the total contract price of all sales made during that respective year.

A dealer who desires to compute income by the installment method shall maintain accounting records in such a manner as to enable an accurate computation to be made by such method in accordance with the provisions of this section, section 446, and Sec. 1.446-1.

(2) Gross profit and total contract price. For purposes of paragraph (e)(1) of this section, in computing the gross profit realized or to be realized on the total sales on the installment plan, there shall be included in the total selling price and, thus, in the total contract price of all such sales.

(i) The amount of carrying charges or interest which is determined at the time of each sale and is added to the established cash selling price of such property and is treated as part of the selling price for customer billing purposes, and

(ii) In the case of sales made in taxable years beginning on or after January 1, 1960, the amount of carrying charges or interest determined with respect to such sales which are added contemporaneously with the sale on the books of account of the seller but are treated as periodic service charges for customer billing purposes.

Any change in the amount of the carrying charges or interest in a year subsequent to the sale will not affect the computation of the gross profit for the year of sale but will be taken into account at the time the carrying charges or interest are adjusted. The application of this paragraph (e)(2) to carrying charges or interest described in paragraph (e)(2)(ii) of this section may be illustrated by the following example:

Example. X Corporation makes sales on the traditional installment plan. The customer's order specifies that the total price consists of a cash price plus a ``time price differential'' of 1\1/2\ percent per month on the outstanding balance in the customer's account, and the customer is billed in this manner. On its books and for purposes of reporting to stockholders, X Corporation consistently makes the following entries each month when it records its sales. A debit entry is make to accounts receivable (for the total price) and balancing credit entries are made to sales (for the established selling price) and to a reserve account for collection expense (for the amount of the time price differential). In computing the gross profit realized or to be realized on the total sales on the installment plan, the total selling price and, thus, the total contract price for purposes of this paragraph (e) would, with respect to sales made in taxable years beginning on or after January 1, 1960, include the time price differential.

(3) Carrying charges not included in total contract price. In the case of sales by dealers in personal property made during taxable years beginning after December 31, 1963, the income from which is returned on the installment method, if the carrying charges or interest with respect to such sales is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest.

(f) Other accounting methods. If the vendor chooses as a matter of consistent practice to return the income from installment sales on an accrual method (,) such a course is permissible.

(g) Records. In adopting the installment method of accounting the Seller must maintain such records as are necessary to clearly reflect income in accordance with this section, section 446 and Sec. 1.446-1.

(h) Effective date. This section applies for taxable years beginning after December 31, 1953, and ending after August 16, 1954, but generally does not apply to sales made after December 31, 1987, in taxable years ending after such date. For sales made after December 31, 1987, sales made by a dealer in personal or real property shall not be treated as sales on the installment plan. (However, see section 453(l)(2) for exceptions to this rule.)

PRIVATE LETTER RULING 200648012

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: December 1, 2006
June 7, 2006

Section 453 — Installment Sale Treatment

LEGEND:

Asset # 1 =
Asset # 2 =
Buyers =
Date 1 =
Date 2 =
Taxpayer =
Year 1 =
$x =
$y =

Dear ***:

This is in reply to your request pursuant to section 453(d)(3) of the Internal Revenue Code and section 15a.453-1(d)(4) of the Temporary Income Tax Regulations for consent to revoke an election out of the installment method.

FACTS:

During Year 1, Taxpayer sold Asset # 1 and Asset # 2 to Buyers. The terms of sale provided for full payment for Asset # 1 at the time of closing. The Buyers made a down payment on Asset # 2 and gave the Taxpayer their interest bearing note for the balance of the sales price.

It has been represented that the Taxpayer's original federal income tax return for Year 1 was filed on extension on Date 2. The Taxpayer has indicated that he intended to recognize the gain on the sale of Asset # 2 as the Buyers made payments on their note. However, the return preparer did not prepare the tax return in a manner consistent with the Taxpayer's instruction; the entire gain was reported on the federal income tax return for Year 1.

When the Taxpayer changed tax return preparers, the new return preparer discovered that the entire gain from the Year 1 sale had been reported on the return for Year 1. As a result of the discovery of the return treatment, the Taxpayer requested approval to revoke the election out of the installment method.

LAW AND ANALYSIS:

Section 453(a) of the Code provides that, generally, a taxpayer shall report income from an installment sale under the installment method. Section 453(b) defines an installment sale as a disposition of property for which at least one payment is to be received after the close of the taxable year of the disposition.

Section 15a.453-1(b)(3)(i) of the Temporary Regulations defines "payment" to include amounts actually or constructively received in the taxable year under an installment obligation.

Section 453(d)(1) of the Code and section 15a.453-1(d)(1) of the Temporary Regulations provides that a taxpayer may elect out of the installment method in the manner prescribed by the regulations. Section 15a.453-1(d)(3) of the Temporary Regulations provides that a taxpayer who reports an amount realized equal to the selling price including the full face amount of an installment obligation on a timely filed tax return for the taxable year in which the installment sale occurs is considered to have elected out of the installment method.

Except as otherwise provided in the Regulations, section 453(d)(2) of the Code requires a taxpayer who desires to elect out of the installment method to do so on or before the due date (including extensions) of the taxpayer's federal income tax return for the taxable year of the sale. Section 15a.453-1(d)(4) of the Temporary Regulations provides that an election under section 453(d)(1) of the Code is generally irrevocable. An election may be revoked only with the consent of the Internal Revenue Service. Section 15a.453-1(d)(4) provides that revocation of an election out of the installment method is retroactive and will not be permitted when one of its purposes is the avoidance of federal income taxes.

The Taxpayer has represented that he advised the tax return preparer that he intended to pay tax on the gain as he received payments on the Buyer's note. However, the return preparer included the entire gain from the sale on the taxpayer's Year 1 return. When the Taxpayer changed return preparer's and the new return preparer discovered the return treatment of the Year 1 sale, the Taxpayer was advised to request Internal Revenue Service approval to revoke the election out of the installment method.
The information provided and the representations made indicate that: (1) the Buyers have made timely payment of all required principal interest payments on their note and the note is not in default; (2) the Taxpayer did not incur any significant capital or ordinary losses in any year subsequent to Year 1 and has no unrealized loss that he intends to realize to offset installment gain if revocation of the election out of the installment method is

approved; (3) the Taxpayer made no installment sales prior to or subsequent to Year 1 that were reported on the installment method; (4) the Taxpayer has made no installment sales, other than the subject sale, prior or subsequent to Year 1 that were not reported on the installment method.

The fact that the applicable tax rates were reduced after Year 1, the year in which the sale took place, would generally result in denial of consent for revocation of an election out of the installment method on the basis that the request to revoke the election would be based on hindsight and the intent to avoid federal income taxes. Although the tax rates were reduced after Year 1, the reduction occurred before the Taxpayer's return for Year 1 was filed on extension. At the time the return was filed, the reduction in tax rates had already been enacted. Based upon the timing of the enactment of the change in tax rates and the information described above, it was evident at the time the Taxpayer's Year 1 return was filed that the use of the installment method would have been beneficial for the Taxpayer.

CONCLUSION:

Based on careful consideration of all of the information submitted and the representations made, we conclude that the Taxpayer will be allowed to revoke the election out of the installment method with respect to the Year 1 sale of Asset # 2.

Permission to revoke the election out of the installment method of reporting for the Year 1 sale of Asset # 2 is granted for the period that ends 75 days after the date of this letter. In order to revoke the election out of the installment method for the sale at issue, the Taxpayer must file an amended federal income tax return for Year 1 and any other previously filed returns on which a portion of the gain from the sale is reportable under the installment method. A copy of this letter ruling must be attached to each of the amended return(s).

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, including the computation of gain to be reported under the installment method.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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 rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This ruling is conditioned upon the accuracy of that information and those representations. 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,

Thomas A. Luxner
Chief, Branch 1
(Income Tax & Accounting)
This document may not be used or cited as precedent.

TREASURY DECISION 8535

RULES and REGULATIONS
DEPARTMENT OF THE TREASURY
26 CFR Parts 1 and 15a (TD 8535)

1031 Like-kind Exchanges of Property—Coordination With Section 453
Wednesday, April 20, 1994

AGENCY:

Internal Revenue Service (IRS), Treasury

ACTION:

Final and temporary regulations

SUMMARY:

This document contains final income tax regulations under section 1031(a)(3) of the Internal Revenue Code of 1986 relating to the coordination of deferred like-kind exchanges described in section 1031(a)(3) with the installment sale rules of section 453. The final regulations affect taxpayers who engage in certain like-kind exchanges of property under section 1031.

DATES:

These regulations are effective April 20, 1994. For dates of applicability, see Sections 1.1031(b)-2(d) and 1.1031(k)-1(j)(2) of the regulations.

FOR FURTHER INFORMATION CONTACT:

Christopher F. Kane at (202) 622-4950, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

On May 1, 1991, the IRS published in the Federal Register (56 FR 19933) final regulations under section 1031(a)(3) of the Internal Revenue Code relating to deferred like-kind exchanges. Section 1.1031(k)-1(j)(2) of the regulations, relating to the coordination of section 1031(a)(3) with the installment sale provisions of section 453, is reserved. On November 2, 1992, the IRS published a notice of proposed rulemaking in the Federal Register (57 FR 49432) coordinating section 1031(a)(3) with the installment sale provisions of section 453. After consideration of the written comments received regarding the proposed regulations, the regulations are adopted as amended by this Treasury decision. This Treasury decision amends Section 1.1031(b)-2 of 26 CFR part 1, Income Tax Regulations, adds the text of Section 1.1031(k)-1(j)(2), and amends Section 15a.453-1(b)(3)(i) of 26 CFR part 15a.

Technical Background

In a typical deferred exchange, the taxpayer may require the transferee to secure its promise to acquire replacement property with a cash funded escrow account or trust. Alternatively, the taxpayer may retain an intermediary to arrange for the transfer of replacement property to the taxpayer. Section 1.1031(k)-1(g) provides certain safe harbors that, if followed, ensure that these arrangements do not cause the transaction to be treated as a taxable sale rather than a deferred exchange for purposes of section 1031. Section 453(a) generally provides that income from an installment sale is taken into account under the installment method as payments are made. Section 15a.453- 1(b)(3)(i) of the regulations provides that the receipt of an evidence of indebtedness that is secured directly or indirectly by cash or a cash equivalent is treated as the receipt of a payment. That section also provides that a payment includes amounts actually or constructively received under an installment obligation.

These final regulations provide rules that coordinate the safe harbor provisions of Section 1.1031(k)-1(g) with the installment sale rules that determine when a taxpayer is in receipt of a payment under section 453 and Section 15a.453-1(b)(3)(i).

Description of Provisions

The final regulations under Section 1.1031(k)-1(g) (3) and (4) provide certain safe harbors under which taxpayers are treated as not being in actual or constructive receipt of money or other property held in a qualified escrow account, qualified trust, or by a qualified intermediary. These final regulations generally adopt the same safe harbors for the purpose of determining whether a taxpayer is in receipt of payment under section 453 and Section 15a.453-1(b)(3)(i) if, at the beginning of the exchange period, the taxpayer has a bona fide intent to enter into a deferred exchange. The qualified escrow account, qualified trust, or qualified intermediary is disregarded for purposes of section 453 and Section 15a.453-1(b)(3)(i) until the earlier of (a) the time the safe harbor would otherwise cease to apply for purposes of section 1031 (e.g., when the taxpayer has the immediate right to receive the funds held in the qualified escrow account), or (b) the end of the exchange period. Thus, subject to the other requirements of sections 453 and 453A and the related regulations, taxpayers who use the safe harbors of the existing 1031 regulations and meet the requirements of these final regulations will be entitled to report gain recognized on the deferred exchange under the installment method.

Several commentators requested that the bona fide intent requirement be clarified by providing either examples or presumptions. Whether a particular taxpayer has a bona fide intent to enter into a deferred exchange is determined on the basis of all relevant facts and circumstances. Because the presumptions suggested by commentators would emphasize certain factors that in many cases should not be determinative, the final regulations do not contain rules setting forth presumptions. However, the final regulations clarify that a taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period. In addition, two examples have been added to the final regulations in which the bona fide intent requirement is determined to have been satisfied. These examples are intended to be illustrative only, and do not represent either the minimum steps required to establish bona fide intent or safe harbors pursuant to which a bona fide intent will in other contexts be assumed to exist.

The regulations provide a special rule for deferred exchanges involving qualified intermediaries. Under this rule, a taxpayer in receipt of an evidence of indebtedness of the qualified intermediary's transferee is treated as receiving an evidence of indebtedness of the transferee of the relinquished property, even though these regulations generally treat the qualified intermediary as having acquired and transferred the relinquished property for other purposes. Therefore, for purposes of section 453 and Section 15a.453- 1(b)(3)(i), the receipt by the taxpayer of such an evidence of indebtedness is treated as the receipt of an evidence of indebtedness of the person acquiring the relinquished property from the taxpayer and is not considered a payment under section 453.

One commentator was concerned that the treatment provided by the special rule terminates at the end of the exchange period even if the note remains outstanding. The final regulations make clear that this rule applies beyond the end of the exchange period. Another commentator suggested that the special rule that treats indebtedness of the qualified intermediary's transferee as indebtedness of the person acquiring relinquished property from the taxpayer for purposes of section 453 and Section 15a.453-1(b)(3)(i) should also apply to simultaneous exchanges under Section 1.1031(b)-2. This comment has been adopted, as reflected in amendments to Section 1.1031(b)-2.

Another commentator recommended that the regulations provide that the distribution of an installment note to the taxpayer at any time by a qualified intermediary would not terminate the applicability of the qualified intermediary safe harbor. The Internal Revenue Service and the Treasury do not believe a special exception to the limitations contained in Section 1.1031(k)- 1(g)(4) (ii) and (vi) (relating to the taxpayer's right to receive or otherwise obtain the benefits of money or other property held by a qualified intermediary) should be provided for installment notes. Rather, Section 1.1031(k)- 1(g)(4)(vii) provides sufficient flexibility by permitting the receipt of money or other property (including an installment note) by the taxpayer directly from a transferee without affecting the applicability of the qualified intermediary safe harbor. Therefore, this comment has not been adopted.

Another commentator suggested that certain interest payments made on the installment note during the exchange period be treated as fee income to the qualified intermediary and not as interest income to the taxpayer. Section 1.1031(k)-1(h)(2) specifies that interest payments received by the taxpayer, whether received in cash or property (including like-kind property), are to be treated as income to the taxpayer. The determination of whether interest payments retained by a qualified intermediary should be treated as received by the taxpayer, and thereby represent income to the taxpayer, is beyond the scope of this regulation and may be the subject of future guidance.

One commentator requested that the regulations address the timing of gain recognition in deferred exchanges involving assumptions of liabilities. The Internal Revenue Service and the Treasury are currently studying the circumstances under which, and the extent to which, gain attributable to assumptions of liabilities in like-kind exchanges (including simultaneous exchanges) should be eligible for deferral under the installment method. Among other things, this process will include an examination of the rules proposed under section 453(f)(6) in 1984. Accordingly, this final regulation does not address these issues.

Two commentators requested that the regulations consider issues relating to the timing of receipt of income after the end of the exchange period in cases where the delivery of money or other property is delayed due to events such as breach of contract or bankruptcy. Because section 1031(a)(3) requires deferred exchanges to be completed by the end of the exchange period, the safe harbors from the constructive receipt rules provided by Section 1.1031(k)- 1(g) (3) and (4) have no application after that period. Whether a taxpayer is in receipt of money or other property held in a qualified escrow account or qualified trust or by a qualified intermediary after the end of the exchange period is determined under general principles of federal income tax law. Therefore, the final regulations do not provide specific guidance regarding the timing of receipt of income where delivery of the money or other property held in a qualified escrow account or a qualified trust, or by a qualified intermediary is delayed beyond the end of the exchange period.

Several additional comments were received pertaining to issues that may arise when an installment note is used in a deferred like-kind exchange. Commentators suggested that guidance be provided on the tax consequences of making the installment note payable to a qualified intermediary. Commentators also wanted to know the consequences of a qualified intermediary's disposition of a note to a third party during the exchange period. Commentators requested guidance on the treatment of principal payments made on an installment note during the exchange period. One commentator requested guidance on the tax consequences of a reversion to the transferee of cash held in a qualified escrow account or qualified trust followed by the transferee's issuance of an installment note to the taxpayer at the end of the exchange period. Commentators also suggested that the final regulations address the treatment of issues arising from deferred exchanges of multiple assets.

The issues raised by these comments are broader than the scope of these regulations. Resolution of these issues would affect not only deferred like-kind exchanges spanning more than one tax year, but also such exchanges taking place within one tax year. In addition, these issues may also involve the character of income rather than the timing of the receipt of income. Therefore, the final regulations do not address these comments. However, the Internal Revenue Service will take these issues into consideration in issuing further guidance in this area.

Finally, under these regulations, taxpayers may choose to apply the safe harbors retroactively to transfers of property occurring on or after May 16, 1990. However, if taxpayers reported gain that qualifies for installment method reporting under these regulations in the year they transferred the relinquished property, they in effect elected out of the installment method. In the preamble to the proposed regulations, the Internal Revenue Service

requested comments on whether the Service should publish a revenue procedure providing simplified procedures under which those taxpayers who elected out of the installment method could use the installment method in reporting gain on those transactions. Because commentators expressed only minimal interest in this revenue procedure, the Service will not issue such a revenue procedure or similar guidance.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking published in the Federal Register on November 2, 1992 (57 FR 49432) was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal author of these regulations is Christopher F. Kane of the Office of Assistant Chief Counsel (Income Tax and Accounting), Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Parts 1 and 15a

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendment to the Regulations

Accordingly, 26 CFR parts 1 and 15a are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805

Par. 2. Section 1.1031(b)-2 is amended as follows:

1. Paragraph (b) is revised.

2. Paragraphs (c) and (d) are added.

3. The added and revised provisions read as follows:

Section 1.1031(b)-(2) Safe harbor for qualified intermediaries.

(b) In the case of simultaneous exchanges of like-kind properties involving a qualified intermediary (as defined in Section 1.1031(k)-1(g)(4)(iii)), the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter.

(c) Paragraph (a) of this section applies to transfers of property made by taxpayers on or after June 10, 1991.

(d) Paragraph (b) of this section applies to transfers of property made by taxpayers on or after April 20, 1994. A taxpayer may choose to apply paragraph (b) of this section to transfers of property made on or after June 10, 1991.

Par. 3. In Section 1.1031(k)-1, the text of paragraph (j)(2) is added to read as follows:

Section 1.1031(k)-1 Treatment of deferred exchanges.

(j)(2) Coordination with section 453—

(i) Qualified escrow accounts and qualified trusts.

Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust. This paragraph (j)(2)(i) ceases to apply at the earlier of –

(A) The time described in paragraph (g)(3)(iv) of this section; or

(B) The end of the exchange period.

(ii) Qualified intermediaries.

Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of –

(A) The time described in paragraph (g)(4)(vi) of this section; or

(B) The end of the exchange period.

(iii) Transferee indebtedness.

In the case of a transaction described in paragraph (j)(2)(ii) of this section, the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and Section 15a.453- 1(b)(3)(i) of this chapter.

(iv) Bona fide intent requirement.

The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period.

(v) Disqualified property.

The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply if the relinquished property is disqualified property. For purposes of this paragraph (j)(2), disqualified property means property that is not held for productive use in a trade or business or for investment or is property described in section 1031(a)(2).

(vi) Examples.

This paragraph (j)(2) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B is a calendar year taxpayer who agrees to enter into a deferred exchange. Pursuant to the agreement, B is to transfer real property X. Real property X, which has been held by B for investment, is unencumbered and has a fair market value of $100,000 at the time of transfer. B's adjusted basis in real property X at that time is $60,000. B identifies a single like-kind replacement property before the end of the identification period, and B receives the replacement property before the end of the exchange period. The transaction qualifies as a like-kind exchange under section 1031.

Example 1.

(i) On September 22, 1994, B transfers real property X to C and C agrees to acquire like-kind property and deliver it to B. On that date B has a bona fide intent to enter into a deferred exchange. C's obligation, which is not payable on demand or readily tradable, is secured by $100,000 in cash. The $100,000 is deposited by C in an escrow account that is a qualified escrow account under paragraph (g)(3) of this section. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash deposited in the escrow account until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers the replacement property to B. The $20,000 in cash remaining in the qualified escrow account is distributed to B at that time.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 in cash that B receives in the exchange. Under paragraph (j)(2)(i) of this section, the qualified escrow account is disregarded for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of C's obligation on September 22, 1994, does not constitute a payment. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from the qualified escrow account. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method. See section 453(f)(6) for special rules for determining total contract price and gross profit in the case of an exchange described in section 1031(b).

Example 2.

(i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. C is a qualified intermediary under paragraph (g)(4) of this section. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the remaining $20,000 from the transfer of real property X to B.

(ii) Under section 1031(b), B recognizes gain to the extent of the $20,000 cash B receives in the exchange. Under paragraph (j)(2)(ii) of this section, any agency relationship between B and C is disregarded for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the $20,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain in 1995 under the installment method.

Example 3.

(i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for $100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire $100,000 from the sale of real property X to B.
(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis in real property X ($60,000), or $40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the $100,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the 40,000 gain in 1995 under the installment method.

Example 4.

(i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is a qualified intermediary under paragraph (g)(4) of this section. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who then transfers it to D for $80,000 in cash and D's 10-year installment obligation for $20,000. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. D's obligation bears adequate stated interest and is not payable on demand or readily tradable. On March 11, 1995, C acquires replacement property having a fair market value of $80,000 and delivers it, along with the $20,000 installment obligation, to B.

(ii) Under section 1031(b), $20,000 of B's gain (i.e., the amount of the installment obligation B receives in the exchange) does not qualify for nonrecognition under section 1031(a). Under paragraphs (j)(2) (ii) and (iii) of this section, B's receipt of D's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of the obligation is not treated as a payment. Subject to the other requirements of sections 453 and 453A, B may report the $20,000 gain under the installment method on receiving payments from D on the obligation.

Example 5.

(i) B is a corporation that has held real property X to expand its manufacturing operations. However, at a meeting in November 1994, B's directors decide that real property X is not suitable for the planned expansion, and authorize a like-kind exchange of this property for property that would be suitable for the planned expansion. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On November 28, 1994, pursuant to the agreement, B transfers real property X to C, who then transfers it to D for $100,000 in cash. The exchange agreement does not include any limitations or conditions that make it unreasonable to believe that like-kind replacement property will be acquired before the end of the exchange period. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period, if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. In early January 1995, B's directors meet and decide that it is not feasible to proceed with the planned expansion due to a business downturn reflected in B's preliminary financial reports for the last quarter of 1994. Thus, B's directors instruct C to stop seeking replacement property. C delivers the $100,000 cash to B on January 12, 1995, at the end of the identification period. Both the decision to exchange real property X for other property and the decision to cease seeking replacement property because of B's business downturn are recorded in the minutes of the directors' meetings. There are no other facts or circumstances that would indicate whether, on November 28, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The directors' authorization of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and Section 15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment until January 12, 1995, on receipt of the $100,000 cash from C. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

Example 6.

(i) B has held real property X for use in its trade or business, but decides to transfer that property because it is no longer suitable for B's planned expansion of its commercial enterprise. B and D agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to D on September 22, 1994, and D deposits $100,000 cash in a qualified escrow account as security for D's obligation under the agreement to transfer replacement property to B before the end of the exchange period. D's obligation is not payable on demand or readily tradable. The agreement provides that B is not required to accept any property that is not zoned for commercial use. Before the end of the identification period, B identifies real properties J, K, and L, all zoned for residential use, as replacement properties. Any one of these properties, rezoned for commercial use, would be suitable for B's planned expansion. In recent years, the zoning board with jurisdiction over properties J, K, and L has rezoned similar properties for commercial use. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in the escrow account until the earlier of the time that the zoning board determines, after the end of the identification period, that it will not rezone the properties for commercial use or the end of the exchange period. On January 5, 1995, the zoning board decides that none of the properties will be rezoned for commercial use. Pursuant to the exchange agreement, B receives the $100,000 cash from the escrow on January 5, 1995. There are no other facts or circumstances that would indicate whether, on September 22, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized ($100,000) over the adjusted basis of real property X ($60,000), or $40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make it unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and Section 15a.453- 1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the $100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the $40,000 gain in 1995 under the installment method.

(vii) Effective date.

This paragraph (j)(2) is effective for transfers of property occurring on or after April 20, 1994. Taxpayers may apply this paragraph (j)(2) to transfers of property occurring before April 20, 1994, but on or after June 10, 1991, if those transfers otherwise meet the requirements of Section 1.1031(k)-1. In addition, taxpayers may apply this paragraph (j)(2) to transfers of property occurring before June 10, 1991, but on or after May 16, 1990, if those transfers otherwise meet the requirements of Section 1.1031(k)- 1 or follow the guidance of IA-237-84 published in 1990-1, C.B. See Section 601.601(d)(2)(ii)(b) of this chapter.

PART 15a –

TEMPORARY INCOME TAX REGULATIONS UNDER THE INSTALLMENT SALES REVISION ACT

Par. 4. The authority citation for part 15a is revised to read as follows:

Authority: 26 U.S.C. 453(i) and 7805.

Par. 5. In Section 15a.453-1, paragraph (b)(3)(i) is amended by adding a sentence, after the current first sentence, after the current third sentence, and after the current fourth sentence, respectively, to read as follows:

Section 15a.453-1 Installment method reporting for sales of real property and casual sales of personal property.

(b)(3) Payment –

(i) In general.

For special rules regarding the receipt of an evidence of indebtedness of a transferee of a qualified intermediary, see Sections 1.1031(b)-2(b) and 1.1031(k)-1(j)(2)(iii) of this chapter. For a special rule regarding a transfer of property to a qualified intermediary followed by the sale of such property by the qualified intermediary, see Section 1.1031(k)-1(j)(2)(ii) of this chapter. For a special rule regarding a transfer of property in exchange for an obligation that is secured by cash or a cash equivalent held in a qualified escrow account or a qualified trust, see Section 1.1031(k)-1(j)(2)(i) of this chapter.

Approved: March 16, 1994

Margaret Milner Richardson,
Commissioner of Internal Revenue
Leslie Samuels,
Assistant Secretary of the Treasury

SECTION 721 EXCHANGE INTO AN UPREIT

Sec. 1.721-1

Nonrecognition of gain or loss on contribution.

(a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of Sec. 1.731-1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and Sec. 1.752-1.

(b)(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is:

(i) Compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c);

(ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

(c) Underwritings of partnership interests—

(1) In general. For the purpose of section 721, if a person acquires a partnership interest from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the partnership interest is treated as transferring cash directly to the partnership in exchange for the partnership interest and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a partnership issues partnership interests for cash in an underwriting in which either the underwriter is an agent of the partnership or the underwriter's ownership of the partnership interests is transitory.

(2) Effective date. This paragraph (c) is effective for qualified underwriting transactions occurring on or after May 1, 1996.

PRIVATE LETTER RULING 200734003

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: August 24, 2007
May 15, 2007

Section 721 — Nonrecognition of Gain or Loss on Contributions

LEGEND:

Trust =
State =
X =
Y =
Beneficiaries =
a =
b =
c =
d =
e =
f =

Dear *** :

This letter responds to a letter dated March 24, 2006, and subsequent correspondence, submitted on behalf of Trust requesting rulings under Section 721 of the Internal Revenue Code.

FACTS

The information submitted states that Trust was formed on a under the laws of State. As of b, Trust had a security portfolio with a total asset value of approximately $c. Trust's total equities are approximately $d with a short balance of $e. Trust purchases certain securities on margin, and the current margin balance is approximately $f.

Under its terms, Trust has been divided into two equal shares for X and Y, and their respective issue. The trustees of Trust have discretion to distribute income and principal to X and Y, and their respective issue. Upon the death of X and Y, their shares are to be divided into equal shares for the benefit of their respective children, the Beneficiaries.

In order to avoid the possible imposition of a corporate trustee and in order to continue family financial and investment planning, Trust's current trustees propose the following transaction. Trust will contribute all of its assets, subject to all of its liabilities, to a new limited liability company ("Company") in exchange for interests in Company. Immediately thereafter, Trust will terminate by distributing its interests in Company to the Beneficiaries.

LAW

Section 721(a) states generally that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. However, Section 721(b) provides that Section 721(a) shall not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of Section 351) if the partnership were incorporated.

Section 1.721-1(a) of the Income Tax Regulations provides that no gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership that is already formed and operating.

Section 301.7701-3(a) of the Procedure and Administration Regulations provides, in part, that a business entity that is not classified as a corporation under Sections 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal income tax purposes as provided in Section 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under Section 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or be disregarded as an entity separate from its owner. Section 301.7701-3(b) provides a default classification for an eligible entity that does not make an election.

Section 301.7701-3(b)(1) provides that, except as provided in Section 1.7701- 3(b)(3), unless the entity elects otherwise, a domestic eligible entity is (i) A partnership if it has two or more members; or (ii) Disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-3(f)(2) provides, in part, that a single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member.

In Rev. Rul. 99-5, 1999-1 C.B. 434, Situation 1, LLC, which for federal tax purposes is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50 percent of A's ownership interest in the LLC is treated as the purchase of a 50 percent interest in each of LLC's assets which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

Rev. Rul. 83-75, 1983-1 C.B. 114, holds that the distribution by a trust of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a charitable organization results in a taxable gain to the trust. Rev. Rul. 83-75 cites Section 1.661(a)-2(f)(1) [sic] and Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940) in determining the proper treatment of an in-kind distribution of property.

Section 1.661(a)-2(f) provides that if property is paid, credited, or required to be distributed in kind by a trust or estate, no gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

In Kenan v. Commissioner, the trustees of a trust were directed to pay a beneficiary $5 million when the beneficiary reached age 40. The trustee paid the beneficiary partly in cash and partly in appreciated securities. The court held that the beneficiary had a general claim against the trust corpus, and the satisfaction of this general claim for an ascertainable value by a transfer of specific assets was an exchange that caused the trust to realize gain.
Section 643(e)(1) provides that the basis of any property received by a beneficiary in a distribution from an estate or trust (property distributed in kind) shall be (A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for (B) any gain or loss recognized to the estate or trust on the distribution.

Section 1.641(b)-3(d) provides, in part, that if a trust is considered terminated under Section 1.641(b)-3 for federal income tax purposes, the gross income, deductions, and credits of the trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the trust.

In this case, Trust will contribute its assets and liabilities to Company, an entity that, because it will have a single owner, will be disregarded as an entity separate from its owner. Therefore, Trust should be treated as continuing to hold the assets and liabilities it will contribute to Company. When Trust terminates upon the distribution of its interests in Company to the Beneficiaries, Trust will be treated as having distributed to the Beneficiaries its assets and liabilities, rather than the interests in Company. As a result of Trust's termination, Company will be converted from a disregarded entity to a partnership. Therefore, the Beneficiaries will be treated as contributing their respective interests in the Trust's former assets and liabilities to Company, a partnership, in exchange for ownership interests in the partnership.

Accordingly, the treatment of Trust's termination will result in each Beneficiary being treated as receiving a pro rata share of all the assets from Trust and assuming a pro rata share of all the liabilities (recourse and nonrecourse) of Trust. Each Beneficiary will then be treated as contributing all such received assets to Company, and Company will be treated as assuming all such liabilities. Therefore, if Company were incorporated, the deemed transfers to Company would not be treated as transfers of property to an investment company (within the meaning of Section 351 (Section 1.351-1(c)).

CONCLUSIONS

Based on the facts and representations submitted by Trust, we conclude that the contribution to Company of all the assets of Trust, subject to Trust's liabilities, in exchange for all of the interests in Company will be disregarded for federal income tax purposes, because Company will be a disregarded entity as described in Section 301.7701-3(b)(1)(ii). In addition, we conclude that the distribution of Trust's assets, subject to Trust's liabilities, to the Beneficiaries will not be a distribution in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed, nor a distribution in satisfaction of a general claim for an ascertainable value, and therefore no gain or loss will be realized by Trust or the Beneficiaries as a result of such distribution (however, the gross income, deductions, and credits of Trust will be, subsequent to the termination, considered the gross income, deductions, and credits of the Beneficiaries succeeding to the property of the trust). Finally, we conclude that the Beneficiaries' deemed contributions to Company of Trust's assets and liabilities that the Beneficiaries will receive from Trust will be non-taxable contributions to the partnership under Section 721.

Except for the specific ruling above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code.

Under a power of attorney on file with this office, we are sending a copy of this letter to Company's authorized representatives.

This ruling is directed only to the taxpayer who requested it. According to Section 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

Leslie H. Finlow
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

PRIVATE LETTER RULING 200728037

Date: March 27, 2007

LEGEND:

Trust =
Operating Partnership =
State X =
Property A =
Property B =
Date 1 =
Date 2 =
Date 3 =
a =

Dear [Redacted Text]:
This responds to a letter dated November 22, 2006, submitted on behalf of Trust, requesting a ruling under §857(b)(6)(D) of the Internal Revenue Code.

FACTS

Trust is a corporation organized in State X that elected to be taxed as a real estate investment trust (REIT) beginning with its taxable year ended Date 1. Trust directly and indirectly owns a percent of the interests in Operating Partnership, a limited partnership that is classified as a disregarded entity for federal income tax purposes. Trust conducts operations and owns properties, both directly and indirectly, through Operating Partnership and other entities.
On Date 3, Operating Partnership entered into a qualified intermediary "QI"arrangement. Pursuant to this QI arrangement, Operating Partnership exchanged certain timberlands (Property A) for other timberlands (Property B) as replacement property (the Exchange). Operating Partnership received no consideration other than Property B in the Exchange.

Trust has made the following representations: (1) Trust will treat the Exchange as an exchange described in §1031(a) of the Code for federal income tax purposes; (2) no gain or loss was recognized in the Exchange as a result of the application of §1031(a); and (3) the Exchange satisfied the requirements for deferred exchanges set forth in § 1.1031(k)-1 of the Income Tax Regulations.

LAW AND ANALYSIS

Section 857(b)(6)(A) of the Code imposes a 100 percent tax on a REIT's net income from prohibited transactions. Section 857(b)(6)(B)(iii) defines the term "prohibited transaction" as the sale or other disposition of property described in § 1221(a)(1) which is not foreclosure property. Section 1221(a)(1) describes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," sometimes referred to as "dealer property."

Section 857(b)(6)(C) of the Code provides a safe harbor for REITs that invest in real property for the production of rental income under which the term "prohibited transaction" does not include a sale of property that is a real estate asset if certain requirements are met. Section 857(b)(6)(C)(iii) sets forth one of these requirements. Section 857(b)(6)(C)(iii) provides that: "(I) during the taxable year the trust does not make more than 7 sales of property (other than sales of foreclosure property or sales to which section 1033 applies), or (II) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the trust as of the beginning of the taxable year." Section 857(b)(6)(D) of the Code extends the safe harbor of §857(b)(6)(C) to REITs that hold real estate assets used in connection with the trade or business of producing timber. Like §857(b)(6)(C), §857(b)(6)(D) provides that a "prohibited transaction" does not include a sale of property that is a real estate asset if certain requirements are met. Section 857(b)(6)(D) sets forth one of these requirements. Like §857(b)(6)(C)(iii), § 857(b)(6)(D)(iv) provides that: "(I) during the taxable year the trust does not make more than 7 sales of property (other than sales of foreclosure property or sales to which section 1033 applies), or (II) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the trust as of the beginning of the taxable year."

Section 1031(a) of the Code generally provides that a taxpayer recognizes no gain or loss when it exchanges property held for productive use in a trade or business or for investment for property of a like kind that also is to be held for productive use or investment.

Section 1.1031(k)-1 of the Regulations provides rules for the application of § 1031 and the regulations promulgated thereunder in the case of a "deferred exchange." For purposes of § 1031, a deferred exchange generally is an exchange in which, pursuant to an agreement, the taxpayer transfer s property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

In applying the safe harbor for prohibited transactions, § 857(b)(6)(D)(iv) of the Code limits on an annual basis the frequency of transactions that a REIT can enter into by reference to the number of "sales" of property and to the basis of property "sold." The legislative history underlying § 857(b)(6) indicates that Congress enacted the prohibited transactions tax to deter REITs from engaging in "ordinary retailing activities such as sales to

customers of condominium units or subdivided lots in a development project." See S. Rep. No. 94-938, 94th Cong., 2d Sess. 470 (1976). The legislative history further indicates that Congress believed that "REITs should have a safe harbor within which they can modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire amount of the appreciation in those assets" and that the restrictions on the availability of the safe harbor would "prevent REITs from using the safe harbor rule to permit them to engage in an active trade or business such as the development and subdivision of land." S. Rep. No. 95-1263, 95th Cong., 2d Sess. 178-79 (1978). Congress extended the safe harbor of § 857(b)(6)(C) to timber REITs by adding § 857(b)(6)(D). See H. Rep. 108-755, 108th Cong., 2d Sess. 321-325 (2004). In the present case, Trust's participation in the Exchange appears to be consistent with the Congressional intent of allowing REITs to modify their portfolios without incurring a prohibitive tax. Moreover, Trust has represented that the Exchange satisfies the requirements for deferred exchanges set forth in § 1.1031(k)-1 of the Regulations and that no gain or loss was recognized on the Exchange as a result of the application of § 1031(a) of the Code. Accordingly, based on these representations, Property A should not be treated as having been "sold" for purposes of § 857(b)(6)(D)(iv).

CONCLUSION

Based solely on the information submitted and the representations made, we rule that the disposition of Property A as part of the Exchange will not be taken into account as a sale of property, and that Property A will not be treated as property sold, for purposes of applying § 857(b)(6)(D)(iv) of the Code to Trust's taxable year ended Date 2. No opinion is expressed or implied with regard to whether Trust qualifies as a REIT under Subchapter M of the Code. In addition, no opinion is expressed or implied as to whether § 1031(a) of the Code applies to the Exchange.

This letter ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Alice M. Bennett
Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)

PRIVATE LETTER RULING 200701008

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: January 5, 2007
September 29, 2006

Section 857 — Taxation of Real Estate Investment Trusts and Their Beneficiaries

LEGEND:

Trust =
Operating Partnership =
State W =
State X =
State Y =
State Z =
Date 1 =
Date 2 =
a =
b =

Dear ***:

This responds to a letter dated March 20, 2006, submitted on behalf of Trust, requesting a ruling under Section 857(b)(6)(C)(iii) of the Internal Revenue Code.

FACTS

Trust is a corporation organized in State W that elected to be taxed as a real estate investment trust ("REIT") beginning with its taxable year ended Date 1.

Trust owns an interest of approximately a percent in Operating Partnership, a State X limited partnership that is classified as a partnership for federal income tax purposes. Other persons own the remaining approximately b percent of the interests in Operating Partnership. Trust is the sole general partner of Operating Partnership. Operating Partnership owns interests in subsidiary entities. Trust conducts operations and owns properties through Operating Partnership and the subsidiary entities.

Trust's current business plan focuses on certain core geographic markets and certain types of properties. Trust is in the process of realigning the portfolio of properties held through Operating Partnership and the subsidiary entities to reflect this business plan.

In furtherance of Trust's business plan, Operating Partnership recently exchanged an improved property in State Y, "Property A" for an improved property in State Z, "Property B." Property B was not subject to liens securing any debt at the time of the acquisition, and Property A was not subject to liens securing any debt at the time it was transferred. Operating Partnership received no consideration other than Property B in the Exchange.

Trust has made the following representations: (1) Trust and Operating Partnership will treat the Exchange as an exchange described in Section 1031(a) of the Code for federal income tax purposes; (2) no gain or loss was recognized on the Exchange as a result of the application of Section 1031(a); and (3) the Exchange satisfied both the requirements for deferred exchanges set forth in Section 1.1031(k)-1 of the Income Tax Regulations and the safe harbor for reverse exchanges set forth in Rev. Proc. 2000-37, 2000-2 C.B. 308, as modified by Rev. Proc. 2004-51, 2004-2 C.B. 294.

LAW AND ANALYSIS

Section 857(b)(6)(A) of the Code imposes a 100-percent tax on a REIT's net income from prohibited transactions. Section 857(b)(6)(B)(iii) defines the term "prohibited transaction" as the sale or other disposition of property described in Section 1221(a)(1) which is not foreclosure property. Section 1221(a)(1) describes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," sometimes referred to as "dealer property."

Section 857(b)(6)(C) of the Code provides a safe harbor under which the term "prohibited transaction" does not include a sale of property that is a real estate asset if certain requirements are met. Section 857(b)(6)(C)(iii) sets forth one of these requirements. Section 857(b)(6)(C)(iii) provides that: "(I) during the taxable year the trust does not make more than 7 sales of property (other than sales of foreclosure property or sales to which Section 1033 applies), or (II) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which Section 1033 applies) sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the trust as of the beginning of the taxable year."

Section 1031(a) of the Code generally provides that a taxpayer recognizes no gain or loss when it exchanges property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that also is to be held for productive use or investment.

Section 1.1031(k)-1 of the Regulations provides rules for the application of Section 1031 and the regulations promulgated thereunder in the case of a "deferred exchange." For purposes of Section 1031, a deferred exchange generally is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

Rev. Proc. 2000-37, as modified by Rev. Proc. 2004-51, provides a "safe harbor" for reverse exchanges. Generally, in a "safe harbor" reverse exchange, an exchange accommodation titleholder acquires replacement property on behalf of a taxpayer pursuant to a qualified exchange accommodation agreement and holds the property until the taxpayer arranges for the transfer of the relinquished property to a transferee. If the safe harbor procedures are satisfied, the exchange accommodation titleholder is treated as the owner of the replacement property until the taxpayer acquires such property in a transaction otherwise qualifying under provisions of Section 1031 of the Code.

In applying the safe harbor for prohibited transactions, Section 857(b)(6)(C)(iii) of the Code limits on an annual basis the frequency of transactions that a REIT can enter into by reference to the number of "sales" of property and to the basis of property "sold." The legislative history underlying section 857(b)(6) indicates that Congress enacted the prohibited transactions tax to deter REITs from engaging in "ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project". See S. Rep. No. 94-938, 94th Cong., 2d Sess. 470 (1976). The legislative history further indicates that Congress believed that "REITs should have a safe harbor within which they can modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire amount of the appreciation in those assets" and that the restrictions on the availability of the safe harbor would "prevent REITs from using the safe harbor to permit them to engage in an active trade or business such as the development and subdivision of land." S. Rep. No. 95-1263, 95th Cong., 2d Sess. 178-179 (1978).

In the present case, Trust's proposed transaction appears to be consistent with the Congressional intent of allowing REITs to modify their portfolios without incurring a prohibitive tax. Moreover, Trust has represented that the Exchange satisfies both the requirements for deferred exchanges set forth in Section 1.1031(k)-1 of the Regulations and the safe harbor for reverse exchanges set forth in Rev. Proc. 2000-37, and that no gain or loss was recognized on the Exchange as a result of the application of Section 1031(a) of the Code. Accordingly, based on these representations, Property A should not be treated as having been "sold" for purposes of Section 857(b)(6)(C)(iii).

CONCLUSION

Based solely on the information submitted and the representations made, we rule that the disposition of Property A as part of the Exchange will not be taken into account as a sale of property, and that Property A will not be treated as property sold, for purposes of applying Section 857(b)(6)(C)(iii) of the Code to Trust's taxable year ending Date 2.

No opinion is expressed or implied with regard to whether Trust qualifies as a REIT under Subchapter M of the Code. In addition, no opinion is expressed or implied as to whether Section 1031(a) of the Code applies to the Exchange.

This ruling is directed only to the taxpayer requesting it.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Alice M. Bennett
Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)
This document may not be used or cited as precedent.

SECTION 1031 EXCHANGE OF INVESTMENT PROPERTY

(See page 3)

SECTION 1033 INVOLUNTARY CONVERSION

Sec. 1.1033(a)-1

Involuntary conversions; nonrecognition of gain.

(a) In general. Section 1033 applies to cases where property is compulsorily or involuntarily converted. An involuntary conversion may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. An involuntary conversion may be a conversion into similar property or into money or into dissimilar property. Section 1033 provides that, under certain specified circumstances, any gain which is realized from an involuntary conversion shall not be recognized. In cases where property is converted into other property similar or related in service or use to the converted property, no gain shall be recognized regardless of when the disposition of the converted property occurred and regardless of whether or not the taxpayer elects to have the gain not recognized. In other types of involuntary conversion cases, however, the proceeds arising from the disposition of the converted property must (within the time limits specified) be reinvested in similar property in order to avoid recognition of any gain realized. Section 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

(b) Special rules. For rules relating to the application of section 1033 to involuntary conversions of a principal residence with respect to which an election has been made under section 121 (relating to gain from sale or exchange of residence of individual who has attained age 65), see paragraph (g) of Sec. 1.121-5. For rules applicable to involuntary conversions of a principal residence occurring before January 1, 1951, see Sec. 1.1033(a)-3. For rules applicable to involuntary conversions of a principal residence occurring after December 31, 1950, and before January 1, 1954, see paragraph (h)(1) of Sec. 1.1034-1. For rules applicable to involuntary conversions of a personal residence occurring after December 31, 1953, see Sec. 1.1033(a)-3. For special rules relating to the election to have section 1034 apply to certain involuntary conversions of a principal reisdence occurring after December 31, 1957, see paragraph (h)(2) of Sec. 1.1034-1. For special rules relating to certain involuntary conversions of real property held either for productive use in trade or business or for investment and occurring after December 31, 1957, see Sec. 1.1033(g)-1. See also special rules applicable to involuntary conversions of property sold pursuant to reclamation laws, livestock destroyed by disease, and livestock sold on account of drought provided in Sec. Sec. 1.1033(c)-1, 1.1033(d)-1, and 1.1033(e)-1, respectively. For rules relating to basis of property acquired through involuntary conversions, see Sec. 1.1033(b)-1. For determination of the period for which the taxpayer has held property acquired as a result of certain involuntary conversions, see section 1223 and regulations issued thereunder. For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231(a) and regulations issued thereunder. For portion of war loss recoveries treated as gain on involuntary conversion, see section 1332(b)(3) and regulations issued thereunder.

Sec. 1.1033(a)-2

Involuntary conversion into similiar property, into money or into dissimilar property.

(a) In general. The term disposition of the converted property means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) Conversion into similar property. If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

(c) Conversion into money or into dissimilar property.

(1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033, the term control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an amended return. If a decision is made to make an election under section 1033(a)(2) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is

realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain from the conversion is realized, unless the taxpayer can show to the satisfaction of the district director—

(i) Reasonable cause for not having filed the application within the required period of time, and

(ii) The filing of such application was made within a reasonable time after the expiration of the required period of time. The application shall contain all of the details in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

See section 1033(g)(4) and Sec. 1.1033(g)-1 for the circumstances under which, in the case of the conversion of real property held either for productive use in trade or business or for investment, the 2-year period referred to in this paragraph (c)(3) shall be extended to 3 years.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(b), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayers unadjusted basis of the replacement property would be determined, in the absence of section 1033(b), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033(a)(2), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033(a)(2) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033(a)(2), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase or a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

(11) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property, and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as a part of the amount realized upon the conversion regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth $100,000 subject to a $50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer $60,000 and awards the mortgagee $50,000 in satisfaction of the mortgage, the entire $110,000 is considered to be the amount realized by the taxpayer. (12) An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

Sec. 1.1033(a)-3
Involuntary conversion of principal residence.

Section 1033 shall apply in the case of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurs before January 1, 1951, or after December 31, 1953. However, section 1033 shall not apply to the seizure, requisition, or condemnation (but not destruction), or the sale or exchange under threat or imminence thereof, of such residence property if the seizure, requisition, condemnation, sale, or exchange occurs after December 31, 1957, and if the taxpayer properly elects under section 1034(i) to treat the transaction as a sale (see paragraph (h)(2)(ii) of Sec. 1.1034-1). See section 121 and paragraphs (d) and (g) of Sec. 1.121-5 for special rules relating to the involuntary conversion of a principal residence of individuals who have attained age 65.

Sec. 1.1033(b)-1
Basis of property acquired as a result of an involuntary conversion.

(a) The provisions of the first sentence of section 1033(b) may be illustrated by the following example:

Example: A's vessel which has an adjusted basis of $100,000 is destroyed in 1950 and A receives in 1951 insurance in the amount of $200,000. If A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. The basis of the new vessel is $100,000; that is, the adjusted basis of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

(b) The provisions of the last sentence of section 1033(b) may be illustrated by the following example:

Example: A taxpayer realizes $22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was $10,000, and he spent in the same year $20,000 for a new barn which resulted in the nonrecognition of $10,000 of the $12,000 gain on the conversion. The basis of the new barn to the taxpayer would be $10,000--the cost of the new barn ($20,000) less the amount of the gain not recognized on the conversion ($10,000). The basis of the new barn would not be a substituted basis in the hands of the taxpayer within the meaning of section 1016(b)(2). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost $8,000 and $12,000, respectively, then the basis of the two barns would be $4,000 and $6,000, respectively, the total basis of the purchased property ($10,000) allocated in proportion to their respective costs (8,000/ 20,000 of $10,000 or $4,000; and 12,000/20,000 of $10,000, or $6,000).

Sec. 1.1033(g)-1
Condemnation of real property held for productive use in trade or business or for investment.

(a) Special rule in general. This section provides special rules for applying section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale). For this purpose, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation. In such cases, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For principles in determining whether the replacement property is property of like kind, see paragraph (b) of Sec. 1.1031(a)-1.

(b) Election to treat outdoor advertising displays as real property—

(1) In general. Under section 1033(g)(3) of the Code, a taxpayer may elect to treat property which constitutes an outdoor advertising display as real property for purposes of chapter 1 of the Code. The election is available for taxable years beginning after December 31, 1970. In the case of an election made on or before July 21, 1981, the election is available whether or not the period for filing a claim for credit or refund under section 6511 has expired. No election may be made with respect to any property for which (i) the investment credit under section 38 has been claimed, or (ii) an election to expense certain depreciable business assets under section 179(a) is in effect. The election once made applies to all outdoor advertising displays of the taxpayer which may be made the subject of an election under this paragraph, including all outdoor advertising displays acquired or constructed by the taxpayer in a taxable year after the taxable year for which the election is made. The election applies with respect to dispositions during the taxable year for which made and all subsequent taxable years (unless an effective revocation is made pursuant to paragraph (b)(2) (ii) or (iii)).

(2) Election—

(i) Time and manner of making election—

(A) In general. Unless otherwise provided in the return or in the instructions for a return for a taxable year, any election made under section 1033(g)(3) shall be made by attaching a statement to the return (or amended return if filed on or before July 21, 1981) for the first taxable year to which the election is to apply. Any election made under this paragraph must be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for such taxable year or July 21, 1981, whichever occurs last. If a taxpayer makes an election (or revokes an election under subdivision (ii) or (iii) of this subparagraph (b) (2)) for a taxable year for which he or she has previously filed a return, the return for that taxable year and all other taxable years affected by the election (or revocation) must be amended to reflect any tax consequences of the election (or revocation). However, no return for a taxable year for which the period for filing a claim for credit or refund under section 6511 has expired may be amended to make any changes other than those resulting from the election (or revocation). In order for the election (or revocation) to be effective, the taxpayer must remit with the amended return any additional tax due resulting from the election (or revocation), notwithstanding the provisions of section 6212(c) or 6501 or the provisions of anyother law which would prevent assessment or collection of such tax.

(B) Statement required when making election. The statement required when making the election must clearly indicate that the election to treat outdoor advertising displays as real property is being made.

(ii) Revocation of election by Commissioner's consent. Except as otherwise provided in paragraph (b)(2)(iii) of this section, an election under section 1033(g)(3) shall be irrevocable unless consent to revoke is obtained from the Commissioner. In order to secure the Commissioner's consent to revoke an election, the taxpayer must file a request for revocation of election with the Commissioner of Internal Revenue, Washington, DC 20224. The request for revocation shall include—

(A) The taxpayer's name, address, and taxpayer identification number,

(B) The date on which and taxable year for which the election was made and the Internal Revenue Service office with which it was filed,

(C) Identification of all outdoor advertising displays of the taxpayer to which the revocation would apply (including the location, date of purchase, and adjusted basis in such property),

(D) The effective date desired for the revocation, and

(E) The reasons for requesting the revocation.

The Commissioner may require such other information as may be necessary in order to determine whether the requested revocation will be permitted. The Commissioner may prescribe administrative procedures (subject to such limitations, terms and conditions as he deems necessary) to obtain his consent to permit the taxpayer to revoke the election. The taxpayer may submit a request for revocation for any taxable year for which the period of limitations for filing a claim for credit or refund or overpayment of tax has not expired. (iii) Revocation where election was made on or before December 11, 1979. In the case of an election made on or before December 11, 1979, the taxpayer may revoke such election provided such revocation is made not later than March 23, 1981. The request for revocation shall be made in conformity with the requirements of paragraph (b)(2)(ii), except that, in lieu of the information required by paragraph (b)(2)(ii)(E), the taxpayer shall state that the revocation is being made pursuant to this paragraph. In addition, the taxpayer must forward, with the statement of revocation, copies of his or her tax returns, including both

the original return and any amended returns, for the taxable year in which the original election was made and for all subsequent years and must remit any additional tax due as a result of the revocation.

(3) Definition of outdoor advertising display. The term outdoor advertising display means a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently atttached to a building or other inherently permanent structure. The term includes highway billboards affixed to the ground with wood or metal poles, pipes, or beams, with or without concrete footings.

(4) Character of replacement property. For purposes of section 1033(g), an interest in real property purchased as replacement property for a compulsorily or involuntarily converted outdoor advertising display (with respect to which an election under this section is in effect) shall be considered property of a like kind as the property converted even though a taxpayer's interest in the replacement property is different from the interest held in the property converted. Thus, for example, a fee simple interest in real estate acquired to replace a converted billboard and a 5-year leasehold interest in the real property on which the billboard was located qualifies as property of a like kind under this section.

(c) Special rule for period within which property must be replaced.

In the case of a disposition described in paragraph (a) of this section, section 1033(a)(2)(B) and Sec. 1.1033(a)-2(c)(3) (relating to the period within which the property must be replaced) shall be applied by substituting 3 years for 2 years. This paragraph shall apply to any disposition described in section 1033(f)(1) and paragraph (a) of this section occurring after December 31, 1974, unless a condemnation proceeding with respect to the property was begun before October 4, 1976. Thus, regardless of when the property is disposed of, the taxpayer will not be eligible for the 3-year replacement period if a condemnation proceeding was begun before October 4, 1976. However, if the property is disposed of after December 31, 1974, and the condemnation proceeding was begun (if at all) after October 4, 1976, then the taxpayer is eligible for the 3-year replacement period. For the purposes of this paragraph, whether a condemnation proceeding is considered as having begun is determined under the applicable State or Federal procedural law.

(d) Limitation on application of special rule. This section shall not apply to the purchase of stock in the acquisition of control of a corporation described in section 1033(a)(2)(A).

REVENUE RULING 83-49

Internal Revenue Service (I.R.S.)
Revenue Ruling
Published: May 21, 1983

INVOLUNTARY CONVERSION; SEVERANCE DAMAGES; CONDEMNATION AWARD

26 CFR 1.1033(g)-1: Condemnation of real property held for productive use in trade or business or for investment

(Also Section 1031; 1.1031(a)-1.)

Involuntary conversion; severance damages; condemnation award. Severance damages received as part of a condemnation award for a portion of the taxpayer's property may be accorded nonrecognition treatment under section 1033(g)(1) of the Code even though the taxpayer reinvests the severance damages in property that is not similar or related in use to the condemned property.

Rev. Ruls. 271 and 80-184 modified.

ISSUES

1) Under the circumstances described below, can a taxpayer defer the recognition of gain realized from "severance damages" received as part of a condemnation award by reinvesting in like-kind property under section 1033(g) of the Internal Revenue Code?

2) If the taxpayer can defer the recognition of gain, what are the taxpayer's bases in the property retained after the condemnation and the replacement property?

FACTS

The taxpayer purchased agricultural land and buildings to be held for investment purposes for 220x dollars. The taxpayer then leased the property to a farmer. Prior to expiration of the lease, a portion of the property was condemned by state X to make way for an interstate highway. The remaining property was not adequate to sustain a profitable farming operation. The taxpayer received 175x dollars from state X for the property actually taken and additional damages of 135x dollars for the reduction in value of the retained property. Damages in addition to an award paid for the property actually condemned, when the value of the retained property has decreased as a result of the condemnation, are called "severance damages." A proper allocation of the taxpayer's basis in the property was 140x dollars to the portion actually taken and 80x dollars to the remaining portion. Therefore, a gain of 35x dollars was realized on the property actually taken, and a gain of 55x dollars was realized on the remaining portion.

Without making an effort either to restore the utility of the retained property or to locate property in the same area as the condemned property, the taxpayer, within the prescribed period of time set forth in section 1033 of the Internal Revenue Code, purchased for 350x dollars a large motel complex occupying an acre of ground in a city some distance from the former property's location. The taxpayer actively managed and directly operated the motel for its own account.

LAW AND ANALYSIS

Section 1033(a)(2) of the Code provides that if property, as a result of a condemnation, is compulsorily or involuntarily converted into money, the gain (if any) shall be recognized, except to the extent provided in section 1033(a)(2)(A).

Section 1033(a)(2)(A) of the Code provides that if during a specified period the taxpayer purchases other properties similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized on the conversion exceeds the cost of such other property.

Section 1033(b) of the Code provides that in the case of property purchased by the taxpayer in a transaction described in section 1033(a)(2), which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized.

Section 1033(g)(1) of the Code provides that for purposes of section 1033(a), if real property held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held for either productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1.1033(g)-1(a) of the Income Tax Regulations provides that the principles set forth in section 1.103(a)-1(b) of the regulations should be followed in determining whether property is of a like kind for purposes of section 1033(g) of the Code.

Section 1.1031(a)-1(b) of the regulations provides that the words "like kind" have reference to the nature or character of the property and not its grade or quality. The fact that real estate is improved or unimproved is not material, for that fact relates only to the grade of the property and not to its kind or class.

Section 1.1031(a)-1(a) of the regulations, applying the principles of section 1.1031(a)-1(b), states that property held for productive use in trade or business may replace property held for investment.

Section 1.1031(a)-1(c)(2) of the regulations, also applying the principles of section 1.1031(a)-1(b), provides that a taxpayer who is not a dealer in real estate may exchange city real estate for a ranch or farm.

Rev. Rul. 68-37, 1968-1 C.B. 359, provides that an award of severange damages reduces the basis of the damaged portion of the retained property and any amount received in excess of basis of such portion is treated as gain.

Rev. Rul. 60-240, 1969-1 C.B. 199, holds that gain resulting from receipt of severance damages for farm land may qualify for nonrecognition when the severance damages are expended to acquire farm land adjacent to the remaining property to permit continuation of farming operations as before the condemnation.

Rev. Rul. 72-433, 1972-2 C.B. 470, holds that proceeds received under a threat of condemnation in return for flowage easement rights on a farm that are reinvested in other farm land qualify for nonrecognition of gain under section 1033 of the Code. In reaching this holding the revenue ruling states that there is a close similarity between the nature of proceeds from the involuntary grant of an easement and the severance damages for the loss in value of retained land resulting from a condemnation. The revenue ruling notes that in both situations a property owner retains property that has been affected in some way by the condemnation of related property.

In Rev. Rul. 72-549, 1972-2 C.B. 472, the taxpayer, under threat of condemnation, granted an electric power company an easement and right-of-way over property used in the taxpayer's trade or business. The facts indicate that the property involved was unimproved real property. Subsequently, the taxpayer purchased, for an amount in excess of the amount received from the power company, real property with nominal rental improvements and real property with an apartment building. Both properties were held either for productive use in the trade or business or for investment by the taxpayer. The revenue ruling concludes that the easement and right-of-way that the taxpayer granted and the real estate properties that the taxpayer acquired are both continuing interests in real property and of the same nature and character, and as such qualify as "like kind" property under sections 1031 and 1033(g) of the Code. Thus, both properties acquired by the taxpayer qualify as replacement property for purposes of section 1033.

In McShain v. Commissioner, 68 T.C. 154 (1977), the taxpayer received a condemnation award and elected to replace the condemned property with like kind property. Subsequently, upon realizing that for federal income tax purposes it was not advantageous to defer recognition of the gain, the taxpayer sought to revoke a prior election under section 1033 of the Code by contending that the replacement property was not a valid replacement for the condemned property. The condemned property was originally unimproved realty leased by the taxpayer. While title to improvements erected by the lessee passed to the taxpayer upon expiration of the lease, the taxpayer's investment in the condemned property remained a passive one in which the taxpayer had no major obligation or duties. In contrast, the replacement property was a motor inn constructed, actively managed, and directly operated by the taxpayer. The taxpayer argued that the replacement property was not "similar or related in service or use" to the condemned property within the meaning of section 1033(a)(2)(A), and the Internal Revenue Service did not contest this point. Rather, the Service asserted that nonrecognition was authorized because the replacement property was "like kind" property within the meaning of section 1033(g). The court concluded that the taxpayer had replaced the condemned property with like kind property noting that, under the regulations, property held for investment may be exchanged for property held for productive use in trade or business.

Rev. Rul. 72-433 indicates that severance damages and proceeds received for the involuntary grant of an easement should be treated the same for federal income tax purposes. In Rev. Rul. 72-549, nonrecognition under section 1033(g) of the Code was afforded to a taxpayer that invested the proceeds received for the granting of an easement over unimproved real property in improved real property. Similarly, section 1033(g) can be utilized to afford relief in the severance damages context of the present case. McShain is illustrative of the less stringent "like kind" test under section 1033(g). The present case is similar to Rev. Rul. 72-549 and McShain. Like the taxpayers in those situations, the taxpayer in the present case invested proceeds realized as a result of a condemnation in property not similar or related in service or use to the condemned property. However, the taxpayer's investment of the proceeds realized from the condemnation of agricultural property held as a passive investment in an urban motel complex, actively managed and operated by the taxpayer, constitutes a continuing interest in real property. Since the replacement property is of the same nature as the condemned property, within the meaning of section 1.1031(a)-1(b) of the regulations, and is held by the taxpayer for investment or productive use in a trade or business, the replacement property qualifies as property of a like kind within the meaning of section 1033(g).

HOLDINGS

1) The taxpayer may elect to defer recognition of gain realized from the severance damages received as a part of a condemnation award.

2) The basis of the remaining portion of the original property is zero. If the taxpayer elects to have its gain deferred the basis of the replacement property is, under section 1033(b) of the Code, 260x dollars, representing the cost of the property (350x dollars) reduced by the amount of gain (90x dollars) not recognized.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 271, 1953-2 C.B. 36, holds that gain resulting from receipt of severance damages qualifies for nonrecognition under the predecessor of section 1033 of the Code when the severance damages are used to restore the retained property to its former condition. The revenue ruling also provides that gain will be recognized to the extent that the unexpected portion of such damages exceeds the basis of the retained property. To the extent that it holds that only the unexpended portion of severance damages are applied to reduce a taxpayer's basis in the remaining portion of the original property, Rev. Rul. 271 is modified.

Rev. Rul. 80-184, 1980-2 C.B. 232, to the extent it implies that the nonrecognition provisions of section 1033 of the Code would not apply where severance damages are expended to acquire new property unless there were a showing that it was not economically feasible or practical to invest any more funds in the retained property, is modified.

REVENUE RULING 79-402

Internal Revenue Service (I.R.S.)
Revenue Ruling (Rev. Rul.)
Published: 1979

INVOLUNTARY CONVERSION; REPLACEMENT PROPERTY; LAND AND BUILDING; BASIS

26 CFR 1.1033(c)-1: Basis of property acquired as a result of an involuntary conversion.

(Also Section 167; 1.167(a)-5.)

Involuntary conversion; replacement property; land and building; basis. A taxpayer who elected not to recognize the gain realized on the involuntary conversion of unimproved land subsequently acquired land and improvements and selected only the land as replacement property. The taxpayer must apply the unrecognized gain to reduce the basis of the replacement property as a unit, and the remaining basis must be allocated to the land and improvements in proportion to their respective costs.

ISSUE

Can the unrecognized gain on an involuntary conversion of unimproved land be applied to reduce only the basis of acquired land and not the improvements on the acquired land if only the land is selected as replacement property under the circumstances described below?

FACTS

In 1976, unimproved land with a cost basis of 60x dollars that was held for investment by the taxpayer, an individual, was condemned, and 300x dollars was paid to the taxpayer by the condemning authority. In 1977, the taxpayer acquired improved real property for investment at a purchase price of 600x dollars, of which 200x dollars was allocable to the improvements and 400x dollars was allocable to the land. For purposes of section 1033 of the Internal Revenue Code, the taxpayer elected to treat only the land portion of the 1977 acquisition as replacement property for the property condemned in 1976.

LAW AND ANALYSIS

Section 1033(a)(2) of the Code deals with property that is compulsorily or involuntarily converted into money as a result of condemnation. It provides that if the taxpayer, during the period specified, for the purpose of replacing the property so converted, purchases other property similar or related in service or use to such converted property, gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of the replacement property.

Section 1033(g) of the Code provides that, for purposes of section 1033(a), if real property held for productive use in a trade or business or for investment is, as a result of its condemnation, compulsorily or involuntarily converted, property of a like kind to be held either for productive use in a trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1.1033(f)-1(a) of the Income Tax Regulations refers to section 1.1031(a)-1(b) for principles to be used in determining whether the replacement property is property of like kind.

Section 1.1031(a)-1(b) of the regulations provides that the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Section 1.1031(a)-1(c) states that improved real estate and unimproved real estate are like kind property.

Section 1033(b) of the Code provides that in the case of property purchased by the taxpayer in a transaction described in section 1033(a)(2) that resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized. If the property purchased consists of more than one piece of property, the basis determined shall be allocated to the purchased properties in proportion to their respective costs.

Section 1.167(a)-5 of the regulations provides that in the case of an acquisition of a combination of depreciable and nondepreciable property for a lump sum, the basis for depreciation cannot exceed an amount that bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time.

Rev. Rul. 73-18, 1973-1 C.B. 368, holds that if the replacement property for improved real property sold under threat of condemnation consists of land and a building, the taxpayer's basis in the replacement property must be allocated between the land and building in proportion to their respective costs.

In Aschaffenburg v. United States, 381 F.Supp. 510 (E.D. La. 1974), improved real property was involuntarily converted and replaced by the purchase of an interest in other improved property. The taxpayer argued that since the State paid only for the land, the reinvestment of the payment from the State should only be allocated to the land. The court, citing Rev. Rul. 73-18, held that the cost basis of the replacement property is first reduced by the gain not recognized on the involuntary conversion and then allocated between the improvements and the land in accordance with section 1.167(a)-5 of the regulations.

HOLDING

The unrecognized gain (240x dollars) on the involuntary conversion of the unimproved land must be applied to reduce the basis (600x dollars) of the replacement property as a unit, and the remainder must be allocated to the land and improvements in proportion to their respective costs, notwithstanding the fact that the taxpayer elected only the land portion of the 1977 acquisition to be the replacement property for the property condemned. Thus, the basis of the land is 240x dollars (400x-2/3 of unrecognized gain of 240x) and the basis of improvements is 120x dollars (200x-1/3 of unrecognized gain of 240x).

PRIVATE LETTER RULING 200714002

Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: April 6, 2007
December 22, 2006

Section 1033 — Involuntary Conversions

Legend:

State A =
Corporation 1 =
Corporation 2 =
X # =
Y # =
Date 0 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
A # =
A time =
B time =
Stock Market =
Fund =
Account =
$A =
$B =
$C =

Dear ***:

This letter responds to your ruling request regarding certain of your common stock taken and sold by State A pursuant to State A unclaimed property law. Specifically, you request a ruling that any gain attributable to State A's sale of your common stock in either Corporation 1 or Corporation 2 pursuant to State A unclaimed property law is eligible for nonrecognition of gain under IRC section 1033(a). You request a ruling that the nonrecognition provisions of section 1033(a) will apply provided that you timely reinvest the proceeds from State A's sale of your stock in (1) shares of publicly traded common stock of United States companies, (2) shares of publicly traded preferred stock of United States companies, (3) shares of publicly traded preferred stock of United States companies convertible into shares of common stock, (4) shares of publicly traded common stock of non-United States companies, and/or (5) shares of publicly traded United States mutual funds.

FACTS

You were born on Date 0 which means that you were 90 years old or older during the events discussed in this ruling. Prior to Date 1, you held in certificate form X # shares of Corporation 1. On or about Date 1, State A took control of your Corporation 1 stock pursuant to State A unclaimed property law. On Date 2, State A sold the Corporation 1 stock for $A. State A took control of the proceeds of such sale. Prior to Date 3, you held Y # shares of Corporation 2, stock that had been spun off from Corporation 1. On or about Date 3, State A took control of your Corporation 2 stock pursuant to State A unclaimed property law. On Date 4, State A sold the Corporation 2 stock for $B. State A took control of the proceeds of such sale. At all relevant times the stock of both Corporation 1 and Corporation 2 could be bought and sold on Stock Market.

With the aid of your daughter, on or about Date 5 you filed a claim with State A seeking the return of your Corporation 1 and Corporation 2 stock or the proceeds from the sale of such stock. On or about Date 6, State A paid you the proceeds from the sale of your Corporation 1 stock. On or about Date 7, State A paid you the proceeds from the sale of your Corporation 2 stock.

LAW AND ANALYSIS

Overview

Section 61(a) indicates that, except as otherwise provided in the income tax provisions of the Code, gross income means all income from whatever source derived. Gains from dealings in property are included among the specifically listed items included in gross income. Section 61(a)(3).

Section 1033(a)(2)(A) allows a taxpayer to make an election to limit current recognition of gain with respect to property that (as a result of destruction, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money. The recognized gain is limited to the excess of the amount realized upon such conversion over the cost of other property (hereinafter referred to as qualified replacement property) similar or related in service or use to the converted property (or the cost of purchasing stock in the acquisition of control of a corporation owning such other property), purchased by the taxpayer within a specified period. Section 1033(a)(2)(B) generally requires the replacement property to be purchased during the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

State A Escheat Scheme

Pursuant to State A law, if certain jurisdictional requirements are satisfied corporate common stock escheats to State A if the apparent owner of the stock, as determined from the corporate records, for more than A # years neither claims a dividend on the stock nor corresponds with the corporation or otherwise indicates an interest in the corporation as evidenced by a corporate record. In addition, for escheat to be required the corporation must not know the location of the owner at the end of the A # year period referred to in the preceding sentence.

The corporate issuer of the stock to be escheated (the issuer) must file a report with the State A controller (the controller) that identifies the stock to be escheated. If known to the issuer, the report must also contain the name and the last known address, if there is one, of the person or persons that appear from the corporate records to be the owners of the stock. State A law requires the issuer to transfer the escheated stock to the controller when the report is filed.

Prior to transferring the escheated stock to the controller, the issuer must make reasonable efforts to notify the apparent owner by mail of the impending escheat. State A law generally requires the issuer to transfer the stock to the controller by issuing a duplicate certificate (in the name of the controller if possible) to the controller. The duplicate certificate replaces the certificate issued to the apparent owner. Under certain circumstances, the stock transfer may be accomplished by registering the stock in the name of the controller rather than through the issuance of a duplicate stock certificate.

Within A time of receiving the escheated stock, State A law requires the controller to publish notice in a newspaper of general circulation determined by the controller to be most likely to give notice to the apparent owner of the escheated stock. However, the required notice is simply a general notice to all potential owners of unclaimed property. The notice does not have to identify the escheated property nor the apparent owner of the property. The notice is only required to contain a statement that information concerning the description or amount of escheated property held by the controller may be obtained by persons possessing an interest in such property by contacting the controller. Only if certain conditions are satisfied does State A law require the controller to attempt to mail a notice to the apparent owner of particular property escheated. But State A law does not specify what the mailed notice must contain.

Upon delivery to the controller, State A takes custody of the escheated stock and becomes responsible for its safekeeping. Dividends received by the controller or accrued on the escheated stock from the time of its receipt by the controller until the controller sells the escheated stock are credited, upon receipt by the controller, to the apparent owner's account. If the escheated stock is traded on an established stock exchange, State A law requires the controller to sell the escheated stock at the exchange price.

State A law requires the controller to deposit dividends on the escheated stock, as well as the net proceeds from the sale of such stock into Fund to the credit of Account. However, earnings on the deposited amounts do not accrue to the credit of the apparent owners of the escheated property. State A law also requires the controller to transfer Account funds in excess of $C to the State A general fund. Consequently, State A uses the vast bulk of funds derived from the sale of escheated stock for State A expenditures.

State A provides for a system of escheat and permanent escheat [FN2]. "Escheat" within the meaning of the State A statutes consists of a custodial taking of property rather than the transfer of all ownership rights to the state. The owner of property escheated to State A may file a claim for such property, or the net proceeds from the sale of such property, at any time. The controller is required to consider the claim within B time after it is filed. In doing this the controller may hold a hearing and receive evidence regarding the claim. If the controller denies a claim in whole or in part, or fails to make a decision on such claim within B time, the claimant may assert the claim in a State A court.

State A is not required to pay any interest on claims pertaining to escheated property. Consequently, State A obtains the use of funds derived from escheated property without any obligation to compensate the apparent owners of the escheated property for that use.

Seizure

Whether the taking of stock by State A pursuant to State A unclaimed property law falls within one of the specified actions within section 1033(a), namely, destruction, theft, seizure, requisition or condemnation or threat or imminence thereof, constitutes the first issue to be resolved. Seizure constitutes the only option that might apply to the facts of this case.

Section 1033 provides no definition of the term "seizure". Section 1033's roots extend back to the Revenue Act of 1921. Neither the legislative history to that act or to subsequent acts amending section 1033 or its predecessors provide any guidance regarding the meaning of the term "seizure".

Black's Law Dictionary 8th Ed. (2004) defines "seizure" in part as "[t]he act or an instance of taking possession of a person or property by legal right or process." In Anderson National Bank v. Luckett, 321 U.S. 233 (1931), a national bank challenged the constitutionality of a Kentucky statute requiring it to pay to the state of Kentucky, prior to any judicial determination of abandonment, the amount in certain inactive bank accounts that had been unclaimed for specified periods. Kentucky law required the bank to file a report with the state listing bank deposits presumed to be abandoned as of

an earlier date. The state sent a copy of the list to the sheriff of the county of the deposit account holder. Kentucky law required the sheriff to post a copy of the list of presumptively abandoned accounts at the local courthouse or on a local bulletin board.

Kentucky law authorized the Kentucky state commissioner of revenue to bring a judicial proceeding to establish actual abandonment of funds in state custody attributable to presumptively abandoned bank accounts. A claim to property surrendered to the state could be brought at any time unless there had been a judicial determination of actual abandonment. Even in that case, a person not actually served with notice of the judicial abandonment proceeding and who did not appear and whose claim to the property was not considered during the proceeding could assert a claim to the property during the five year period following the proceeding. Thus, as in the instant case, transfer of the property to the state did not extinguish the owner's rights to the transferred property.

The bank contended that payment of the deposits to the state of Kentucky on the prescribed notice without a prior judicial proceeding deprived the bank and the depositors of property without due process of law. The bank was allowed to raise the due process rights of the depositors because in the absence of such process the bank's turn over of funds to the state would not extinguish the bank's obligations to its depositors.

In response to the bank's contention, the Court noted that the Kentucky statutes themselves, of which the depositors were required to take note, provided notice to all depositors of banks within the state of the conditions under which the balances of inactive accounts would be deemed to be abandoned and paid over to the state. Second, the Court concluded that posting notice on the court house door, an ancient and time honored tradition in Kentucky, regarding the pending transfer of depositors' funds to the state, provided constitutionally adequate notice to the depositors. The Court stated:

We cannot say that the positing of a notice on the door of the court house ... in the circumstances of this case ... is an inadequate means of giving notice of the summary taking into custody of the designated bank accounts by the state. This is the more so because in this case the notice is the immediate prelude to and accompanies the compulsory surrender of the bank balances to the state, unless the depositors in the meantime intervene as claimants. The statutory procedure, so far as it affects depositors, is in the nature of a proceeding in rem, in the course of which property, against which a claim is asserted, is seized [emphasis supplied] or sequestered, and held subject to the appearance and presentation of claims by all those who assert an adverse interest in it. In all such proceedings the seizure [emphasis supplied] of the property is in itself a form of notice of the claim asserted, to those who may claim an interest in the property.

Id. at 244-45. Thus, in a fact pattern very similar to the instance case, the Supreme Court viewed the custodial taking of property by a state for potential permanent escheat as constituting a seizure of the property.

Rev. Rul. 79-269, 1979-2 C.B. 297 further refines the meaning of the term "seizure" for section 1033 purposes. That ruling distinguishes the seizure of property from its requisition or condemnation as follows:

The courts have interpreted the term requisition or condemnation to mean the taking of property by a government authority that has the power to do so against the will of the owner and for the use of the taker. (citations omitted) This interpretation limits the definition of the term to the taking of property for public use.

A seizure occurs when a government authority enters into physical possession of property without authority of a court order with compensation to be determined later. This is different from a requisition or condemnation under which the government pays judicially determined compensation before it takes property, or it takes property under court order before the amount of compensation has been determined. See United States v. Dow, 357 U.S. 17 (1958). But a seizure is like a requisition or condemnation in that it is limited to the taking of property for public use.

Upon receipt of your corporate stock, State A was required to hold the stock and collect any dividends paid on the stock and credit such dividends to you. State A was not required to give you credit for any earnings on the dividends and if certain conditions were met State A could expend the dividends for State A purposes. It is not necessary for us to determine whether State A's ability to derive benefits from the dividends paid on your stock prior to its sale caused the stock to be held for public use. It is only necessary for us to determine whether the public use requirement was satisfied after State A sold your stock.

Upon the sale of your stock, State A law required the controller to deposit the proceeds into Fund. However, State A law also requires the controller to transfer Account funds in excess of $C to the State A general fund. It is not possible to determine with certainty whether the funds from the sale of your stock were transferred from Fund to the State A general fund and expended for State A purposes. However, the total amount of presumed abandoned property that has come under the control of State A and the relatively small amount of such property that the controller is required to maintain in Fund makes it so likely that the funds from the sale of your stock were expended for State A purposes that we find it acceptable to treat the funds as so expended for purposes of this letter ruling. Moreover, State A was not required to pay you interest on the proceeds from the sale of your stock nor were you entitled to any earnings State A derived from such proceeds. We conclude that once State A converted your stock to cash and expended it for State A purposes, there was a seizure of your property within the meaning of section 1033(a).

Involuntary

Section 1033 only defers gains resulting from compulsory or involuntary conversions. The conversion into money or other property must occur from circumstances beyond the taxpayer's control. C. G. Willis, Inc. v. Commissioner, 41 T.C. 468, 474, (1964), aff'd per curiam, 342 F.2d 996 (3d Cir. 1965). Thus, a taxpayer who, in an attempt to obtain insurance proceeds, commits arson by voluntarily paying a third party to burn down the taxpayer's building is not entitled to the benefits of section 1033. Rev. Rul. 82- 74, 1982-1 C.B. 110. Likewise, in Rev. Rul. 69-654, 1969-2 C.B. 162, the Service concluded that a property owner who voluntarily consented to the subsequent conversion of part of his property for the purpose of constructing a school as a condition to receiving approval for the development of his remaining property was not entitled to the tax benefits of section 1033 with regard to the sale of the land on which the school would be constructed. Therefore, if a taxpayer takes voluntary action to cause the

conversion of the taxpayer's property into other property or money, such a conversion does not constitute an involuntary conversion within the meaning of section 1033. You have represented that you did not intentionally fail to exercise ownership rights with regard to your stock for the purpose of having such stock transferred to and sold by the controller pursuant to State A unclaimed property law. Assuming that this representation is true, you would not be precluded from the tax benefits of section 1033 because you took voluntary action to have your stock taken and sold by State A.

The next question to be resolved is whether something less than voluntary action on your part could result in a failure of section 1033's involuntariness requirement. Specifically, the issue to be addressed is whether reckless, grossly negligent, or merely negligent, behavior on your part contributing to the transfer of your stock to State A and its subsequent sale would preclude the application of section 1033 to the sale. We have not found any authority that addresses this question in the context of seizures. However, the issue has been addressed regarding the destruction of property, another type of involuntary conversion covered by section 1033.

"Destruction" in the sense of section 1033 is similar in meaning to the term "casualty" as used within section 165(c)(3). See Rev. Rul. 54-395, 1954-2 C.B. 143, 144, as modified by, Rev. Rul. 59-102, 1959-1 C.B. 200. That a taxpayer's own negligence contributed to a loss incurred by the taxpayer does not prevent the loss from being classified as a casualty loss for section 165 purposes. Heyn v. Commissioner, 46 T.C. 302, 308 (1966), acq., 1967-2 C.B. 2. Treas. Reg. Section 1.165-7(a)(3)(i) provides that an automobile may be the subject of a casualty loss when "[t]he damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act [emphasis supplied] or willful negligence [emphasis supplied] of the taxpayer or of one acting in his behalf." See also Rev. Rul. 54-395 (discussing the possible impact of gross negligence on the characterization of a loss).

You have represented that to the best of your knowledge you did not receive a letter or other notification from either Corporation 1 or Corporation 2 informing you of the pending transfer of your stock prior to those corporations transferring your stock to State A. You have also represented that you did not receive any notice from State A that it had taken custody of your Corporation 1 and Corporation 2 stock prior to its sale, nor did State A notify you that it was going to sell such stock prior to its sale. Under these circumstances an argument still might be made that you were negligent in not taking notice of the State A escheat provisions and in failing to take action to prevent the escheat of your stock. However, as in the case of destruction of property, negligence on your part, even if it existed, would not preclude the application of section 1033 to any gain from the sale of your stock by State A.

Replacement Period

Section 1033(a)(2)(B)(i) generally requires a taxpayer to purchase qualifying replacement property by the close of the period ending 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized. We believe the earliest possible time at which you might be required to realize gain would be upon State A's sale of your stock. Consequently, you will satisfy section 1033's timely replacement requirements provided you invest the proceeds from such sales in qualified replacement property within the period ending 2 years after the close of the taxable year in which State A sold your stock.

Qualified Replacement Property

Generally, replacement property does not qualify as "similar or related in service or use" unless its physical characteristics and end uses are similar to those of the converted property. When an investor owns property that is involuntarily converted, however, the inquiry shifts primarily to the similarity in the relationship of the services or uses which the converted and replacement properties have to the owner-investor. See Rev. Rul. 64-237, 1964-2 C.B. 319. Rev. Rul. 64-237 discusses several factors to consider in determining whether the replacement property is similar to the converted property of the owner-investor, including the nature of the business risks connected with the properties, and the extent and type of management activities the property requires of the owner. Thus, when an investor's property is involuntarily converted, the investor is entitled to consider the manner in which the converted property was held in determining whether the proposed replacement property will be similar or related in service or use.

The Service generally does not distinguish among various types of equity securities for purposes of section 1033. Rev. Rul. 66-355, 1966-2 C.B. 302, holds that a taxpayer can replace common stock that was involuntarily converted with common stock, preferred stock, or mutual fund shares and treat the replacement property as similar or related in service or use within the meaning of section 1033. Nor is foreign property outside the scope of the nonrecognition sections of the Code. Assuming that replacement property is otherwise of the same nature and character of the involuntarily converted property, the fact that it is not in the United States is not determinative. See Rev. Rul. 68-363, 1968-2 C.B. 336 (section 1031 of the Code imposes no qualification as to the place where either the property transferred or the property received is located, and no such qualification can be inferred).

You owned stock in Corporation 1 and Corporation 2 for investment purposes. The risks to and activities required of you with respect to stock in Corporation 1 and stock in Corporation 2 are comparable to the risks of investing in other publicly traded common and preferred stock and stock in publicly traded mutual funds. An investment in debt instruments, however, would not be similar or related in service or use to converted capital stock for purposes of section 1033.

Accordingly we rule as follows:

(1) Pursuant to section 1033(a), you will not be required to recognize gain from State A's sale of your Corporation 1 stock provided you reinvest the proceeds from the sale of such stock in qualifying replacement property by the close of Date 8.

(2) Pursuant to section 1033(a), you will not be required to recognize gain from State A's sale of your Corporation 2 stock provided you reinvest the proceeds from the sale of such stock in qualifying replacement property by the close of Date 9.

(3) For purposes of rulings (1) and (2) the following types of property qualify as qualified replacement property:

(A) shares of publicly traded common stock of United States companies;,

(B) shares of publicly traded preferred stock of United States companies;

(C) shares of publicly traded preferred stock of United States companies convertible into shares of common stock;

(D) shares of publicly traded common stock of non-United States companies; and/or

(E) shares of publicly traded United States mutual funds.

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 you. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 11.04 of Rev. Proc. 2006-1, 2006-1 I.R.B. 1, 49. However, when the criteria in section 11.06 of Rev. Proc. 2006-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it may be 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 rulings contained in this letter are based upon information and representations submitted by you and accompanied by a penalty of perjury statement. 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,

William A. Jackson
Chief, Branch 05
(Income Tax & Accounting)
This document may not be used or cited as precedent.

Private Letter Ruling No. 2006-44019 (PLR 200644019)
Internal Revenue Service (IRS)
Private Letter Ruling (PLR)
Issue: November 3, 2006
July 28, 2006

PRIVATE LETTER RULING 200644019

LEGEND

Taxpayer =
Company-A =
Station-A =
Corporation Z =

Dear ***:

This responds to your letter dated May 1, 2006, requesting a ruling that a property exchange mandated by the Federal Communications Commission (FCC) is an involuntary conversion to which Section 1033 of the Internal Revenue Code applies.

APPLICABLE FACTS:

Taxpayer is the parent of a conglomerate of companies operating in the communications industry. One of its subsidiaries, Company-A, owns and operates a broadcast television station, Station-A, pursuant to a license issued by the FCC.

The FCC regulates the use of our nation's electromagnetic spectrum. Recently, the FCC has implemented a program designed to eliminate a serious interference problem that exists for public safety wireless communications services, such as police, fire, EMT, Homeland Security, and other life-saving "First Responders." The FCC determined that this interference could be eliminated by shifting some current 800 MHz licensed services either to other portions of the 800 MHz band or to the 2 GHz band. This action would make it possible to allocate to public safety communications a dedicated block of spectrum in the 800 MHz band.

Corporation-Z presently operates on portions of the 800 MHz band that will be allocated to public safety wireless communications services. The FCC has ordered that Corporation-Z relocate some of its operations to a portion of the 2 GHz band (1990-2110 MHz) currently licensed to television broadcast stations for Broadcast Auxiliary Services ("BAS"), including Station-A. The primary use of BAS is mobile electronic news-gathering ("ENG"), principally providing on-the-spot television coverage of breaking news stories or other events of interest to the public.

In order to accommodate new licensees in the 2 GHz band, the FCC requires each BAS broadcaster, including Taxpayer, to cease using the 1990-2025 MHz portion of the spectrum by a specified date, and to limit future operations to a band of the spectrum narrower than that on which they currently operate. The equipment presently owned by these broadcasters will not operate (or will not operate without causing interference) on the new bands assigned. The FCC requires that these licensees be provided different equipment, including equipment components to conduct their operations immediately, upon the move to the newly authorized band location.

The FCC requires Corporation-Z to furnish this equipment and to pay related costs necessary to provide the incumbent BAS broadcasters with "comparable facilities" (replacement equipment). The elements of "comparability" required of the BAS replacement equipment are: (1) equivalent channel capacity (both in the number of channels and in operational ability on the narrower bands); (2) equivalent signaling capability, baud rate and access time; (3) coextensive geographic coverage; and (4) equivalent operating costs. The replacement equipment is engineered to make possible substantially the same functionality on the new spectrum licensed to the BAS broadcasters as available in the broadcaster's current operations.

Corporation-Z is obligated to pay the FCC/US Treasury $4.86 billion for the newlylicensed 2 GHz spectrum that it will use. Corporation-Z will receive a credit towards this obligation for $2.06 billion, the FCC-determined value of its net disposition of access to spectrum in the 800 MHz band. It will also receive an aggregate credit (currently estimated at $2.184 billion) for its payment of the actual costs of providing comparable facilities to relocated incumbents in both the 800 MHz band (including public safety licensees) and the 2 GHz band (including BAS broadcasters such as Taxpayer). The resulting estimated balance that will be owed to the FCC/US Treasury will be $616 million.

The FCC requires that Corporation-Z provide all equipment and related costs, or reimburse broadcasters for relocation costs incurred, including those for replacement equipment, integration, testing, and training costs to ensure that the replacement equipment provides comparable functionality to Taxpayer. The replacement equipment will be ordered by Taxpayer. The equipment currently used by Taxpayer will be transferred to Corporation-Z. It is anticipated that Corporation-Z will dispose of the equipment as scrap because it will be unsuitable for any use permitted by the FCC.

Taxpayer will receive only equipment that Corporation-Z provides under the FCC's "comparable facilities" standard. Taxpayer will be reimbursed for only those approved expenditures for related necessary items such as the removal of old equipment, and installation and testing of the replacement equipment. Taxpayer will have no opportunity (as it might with conventional insurance proceeds for loss or damage) to forego reinvestment in similar replacement property, or to keep the conversion proceeds for other purposes.

REQUESTED RULING

Taxpayer requests a ruling that the exchange of its current BAS equipment for newly installed and tested equipment supplied by Corporation-Z pursuant to the FCC Order is an involuntary conversion of property into property similar or related in service or use to the property so converted under Section 1033(a)(1), and that Taxpayer will not recognize income or gain on the exchange.

APPLIABLE LAW AND ANALYSIS

Section 1033(a)(1) provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain shall be recognized.

Section 1.1033(a)-2(b) of the Income Tax Regulations expressly provides that nonrecognition of gain is mandatory when property, as a result of condemnation, is involuntarily converted solely into property similar or related in service or use to the property so converted.

The basic purpose of Section 1033(a) is to allow a taxpayer to replace property or to continue an investment without realizing gain. S. E. Ponticos, Inc., v. Commissioner, 40 T.C. 60, 64 (1963).

Section 1033(a)(1) will apply to the facts of the present case if two requirements are met: (1) the BAS equipment of Taxpayer is compulsorily or involuntarily converted as a result of requisition or condemnation (or threat or imminence thereof); and (2) the replacement equipment is similar or related in service or use to the equipment so converted. These requirements are discussed below.

A. Conversion by Condemnation or Requisition of Private Property.

For purposes of Section 1033, a "conversion" by condemnation or requisition means the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation. Rev. Rul. 57-314, 1957-2 C.B. 523. The Takings Clause of the Fifth Amendment of the United States Constitution states, "nor shall private property be taken for public use, without just compensation." The concept of a governmental taking for purposes of Section 1033(a) has two components: (1) there must be a "taking" of the taxpayer's rights in private property; and (2) the taking must be for "public use."

1. Section 1033 "Taking"

For purposes of Section 1033, a taking by governmental authority includes (1) the physical occupation of a taxpayer's private property, (2) the forced sale of such property or (3) in some circumstances, the regulation against its otherwise lawful use in order to effect a public purpose. With regard to a taking by regulatory action, cases addressing the scope of a Fifth Amendment taking are also instructive as to the scope of involuntary conversions by condemnation or requisition for Section 1033 purposes. For example, the Supreme Court has recognized that government regulation of private property may, in some instances, be so onerous that its effect is tantamount to a direct appropriation compensable under the Fifth Amendment. Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922), involved a state act prohibiting certain mining of coal in such a way as to diminish the support for surface structures. In analyzing the effect of the state law prohibiting certain exploitation of coal mining rights, the Court noted that "while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking." Mahon at 415. Further, the Court reasoned that "to make it commercially impracticable to mine certain coal has very nearly the same effect for constitutional purposes as appropriating or destroying it." Id. at 414.

Building on this concept from Mahon, the Court later stated that a regulatory action will constitute a taking if the regulation or action deprives an owner of "all economically beneficial use" of his property. Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992), held that a state regulation barring development of two beachfront lots in a developed subdivision was a taking. In Lucas, the Court noted that while it has "generally eschewed any 'set formula"' for determining when a given regulation has gone "too far" under Mahon, the Court recognized two categories of regulatory action that are compensable. In the first, the action effects a permanent physical "invasion" of the property, and in the second, the action denies all economically beneficial or productive use of the property. Id. at 1015. The Court stated that, "when the owner of real property has been called upon to sacrifice all economically beneficial uses in the name of the common good, that is, to leave his property economically idle, he has suffered a taking." Id. at 1019.

Situations in which a governmental action has been found not to constitute a Section 1033 requisition or condemnation have generally involved governmental action compelling a taxpayer's transfer of property in the exercise of the police powers of the state in enforcing existing law, including laws intended to protect its citizens' health, well-being, and safety. Generally, a taking as a result of the exercise of governmental police powers will not qualify as an involuntary conversion. For example, a taxpayer's court-ordered disposition of stock, the ownership of which was in violation of the Sherman Anti-Trust Act, does not constitute a taking for public use for purposes of Section 1033. Rev. Rul. 58-11, 1958-1 C.B. 273. See also, Rev. Rul. 57-314, 1957-2 C.B. 523 (the sale of rental properties in order to avoid compliance with building, fire, and health code requirements, even though failure to comply would result in the owner's loss of the legal right to rent such properties, does not fall within Section 1033); and Rev. Rul. 77-370, 1977-2 C.B. 306 (the forced sale of real property to satisfy delinquent taxes was not a conversion as contemplated in Section 1033, because the property was taken merely to satisfy a lien for delinquent taxes, rather than for public use).

In the syllabus to the Lucas opinion, there is a concise distinction drawn between a compensable Fifth Amendment taking and a mere exercise of police power:

Because it is not consistent with the historical compact embodied in the Takings Clause that title to real estate is held subject to the State's subsequent decision to eliminate all economically beneficial use, a regulation having that effect cannot be newly decreed, and sustained, without [compensation] being paid the owner. However, no compensation is owed ... if the State's affirmative decree simply makes explicit what already inheres in the title itself, in the restrictions that background principles of the State's law of property and nuisance already place upon land ownership. Lucas at 1004, citing Scranton v. Wheeler, 179 U.S. 141 (1900).

2. Public Use Requirement

Cases involving challenges to government action as a Fifth Amendment taking are also instructive on the meaning of "public use" as that term is used in the context of involuntary conversion by condemnation or requisition. A "public use" includes the advancement of a "public purpose" by a transfer

of ownership of privately-held property to (i) a governmental entity, or (ii) a private enterprise, provided that in each case there is an advancement of "the broader and more natural interpretation of public use as public purpose." Kelo v. City of New London, 125 S. Ct. 2655 (2005). In Kelo, the city of New London, Connecticut, approved a development plan to increase tax revenues, create jobs, and revitalize an economically depressed area. The Court noted that a broad understanding of "public use" had been the view of the Court for over a century. (See, e.g., Mt. Vernon-Woodberry Cotton Duck Co. v. Alabama Interstate Power Co., 240 U.S. 30 (1916)). In finding that the development plan was a permitted "taking" under the Fifth Amendment, the Court stated:

The public end may be as well or better served through an agency of private enterprise than through a department of government - or so Congress might conclude. We cannot say that public ownership is the sole method of promoting the public purposes of community redevelopment projects.
Id. at 2666, quoting Berman v. Parker, 348 U.S. 26, 34 (1954). Accordingly, for purposes of Section 1033, it makes no difference in the present case that the existing equipment is being transferred to a third party for disposal as opposed to a governmental entity. Similarly, for a "public use" under Section 1033, the scope of 'condemnation' is not restricted to takings for active uses. The question, rather, is whether the taking is for a "public use," including the advancement of a public purpose.

B. Conversion into Property Similar or Related in Service or Use.

With respect to owner-users of converted property, replacement property will be considered to be similar or related in service or use to the converted property if the "physical characteristics and end uses of the converted and replacement properties are closely similar." Rev. Rul. 64-237, 1964 C.B. 319. The Tax court has described the similar or related in service or use requirement as follows:

... [T]he reinvestment must be made in substantially similar business property. Ellis D. Wheeler, 58 T.C. 459, 463 (1965). Stated differently, the statute requires a "reasonably similar continuation of the petitioner's prior commitment of capital and not a departure from it." Harvey J. Johnson v. Commissioner, 43 T.C. 736, 741 (1965). While it is not necessary to acquire property which duplicates exactly that which was converted (Loco Realty Co. v. Com'r, 306 F.2d 207 (8th Cir. 1962), rev'g 35 T.C. 1059 (1961)), the fortuitous circumstance of involuntary conversion does not permit a taxpayer to change the character of his investment without tax consequences." (See Liant Record, Inc. v. Com'r, 303 F.2d 326 (2d Cir. 1962), rev'g 36 T.C. 224 (1961)).

Maloof v. Commissioner, 65 T.C. 263, 269 (1975).

C. Section 1033 is a Relief Provision.

In determining whether a given taxpayer's receipt of replacement property qualifies under Section 1033, courts have long recognized that Section 1033 is a relief provision that should be liberally construed to effect its purpose. E.g., Massillon-Cleveland-Akron Sign Co. v. Commissioner, 15 T.C. 79, 83 (1950) (interpreting former Section 112(f), the precursor to Section 1033). Section 1033 provides a means by which a taxpayer whose enjoyment of his property is interrupted without his consent may arrange to have that interruption ignored for tax purposes, by returning as closely as possible to his original position. Maloof at 270, citing Gaynor News Co. v. Commissioner, 22 T.C. 1172 (1954). What is required is a reasonable degree of continuity in the nature of the assets as well as in the general character of the business. Id. Thus, if the replacement property continues the nature and character of the taxpayer's investment in, or use of, the converted property, it qualifies as replacement property for purposes of Section 1033 and gain is deferred.

APPLICATION OF LAW TO FACTS

A. Was there a condemnation or requisition for Section 1033 purposes?

To implement the FCC's reallocation plan, Taxpayer is required to cease using certain portions of its equipment to avoid interfering with the new licensees of the reallocated spectrum. The FCC-mandated "clearing" of the BAS broadcasters' equipment under the plan is a condemnation within the meaning of Section 1033. The "just compensation" to be provided Taxpayer for such taking consists of the replacement equipment itself and related installation and other capital costs that the FCC has ordered Corporation-Z to pay (the required "comparable facilities"). As described above, such costs paid by Corporation-Z offset dollar-for-dollar the amount otherwise payable by Corporation-Z to the FCC/US Treasury. Thus, the net effect of this offset is that the cost of replacement is borne by the FCC/US Treasury.

As part of its regulation of spectrum to promote the general public interest, the FCC reallocates spectrum to other purposes and relicenses the use of allocated spectrum among both public and private users. A given licensee has no personal property rights vis-a-vis the FCC in its FCC license beyond the limited, specific terms of the license itself. The Communications Act of 1934 ("the Act") provides at 47 U.S.C. Â§ 301 (2005), that the Act's purpose is, "among other things, to maintain the control of the United States over all the channels of radio transmission; and to provide for the use of such channels, but not the ownership thereof, by persons for limited periods of time, under license granted by Federal authority, and no such license shall be construed to create any right, beyond the terms, conditions, and periods of the license." Section 316(a)(1) of the Act provides that any station license or construction permit may be modified by the Commission either for a limited time or for the duration of the term thereof, if in the judgment of the Commission such action will promote the public interest, convenience, and necessity, or cause a party to be more fully in compliance with the provisions of this Act or of any treaty ratified by the United States. Therefore, the FCC's reallocation of spectrum for other uses and the relicensing of such spectrum to new licensees is in itself a regulatory act that does not result in a conversion of any private property rights of the licensee in the license or the spectrum. However, the reallocation of spectrum here has resulted in the condemnation of Taxpayer's related equipment.

Generally, telecommunications equipment, including BAS equipment, may be used only pursuant to and in accordance with FCC authorization and only upon the equipment's compliance with the FCC's technical rules for the radio services in which it is employed. Section 302(a) of the Act provides, in part, that the Commission may, consistent with the public interest, convenience, and necessity, make reasonable regulations governing the interference potential of devices which, in their operation, are capable of emitting radio frequency energy by radiation, conduction, or other

means in sufficient degree to cause harmful interference to radio communications. It further provides that such regulations shall be applicable to the use of such devices.

Section 303 of the Act provides, in part, that the Commission shall, as public convenience, interest, or necessity requires -- "... (e) Regulate the kind of apparatus to be used with respect to its external effects and the purity and sharpness of the emissions from each station and from the apparatus therein... [and] (f) Make such regulations not inconsistent with law as it may deem necessary to prevent interference between stations and to carry out the provisions of this Act...."

When the FCC (1) reallocated certain portions of spectrum previously used by Taxpayer, (2) changed the frequency definitions for the new, narrower channels allocated for BAS use, and (3) ordered that different equipment be provided to assure continuity of essential broadcast services without interruption, it rendered Taxpayer's present equipment completely unusable as of the band clearing date. This action constituted a regulatory Fifth Amendment taking under Mahon and Lucas, supra. As previously noted, an involuntary conversion may occur even without a physical taking of the old equipment. If the reallocated spectrum and the equipment are conceived as one economic unit, then it is more evident that the reallocation of spectrum under these facts is tantamount to the taking of the equipment.

This "economic unit" approach was applied in Masser v.Commissioner, 30 T.C. 741 (1958), when the taxpayer sold property physically adjacent to and used in connection with certain converted property. Under those facts, the Tax Court determined that the subsequent sale was encompassed within the involuntary conversion. Under the economic unit analysis, the Court recognized that certain business assets are so necessarily intertwined that the condemnation of a portion of such assets is in effect a conversion of all of the assets of the economic unit. The Service has formally recognized this same "economic unit" approach for determining the scope of involuntary conversions under Section 1033. Rev. Rul. 59-361, 1959-2 C.B. 183.

Taxpayer's case is analogous to the economic unit rule. The current BAS spectrum and the equipment permitted by the FCC for use on such band form an economic unit. The reallocation and relicensing of the spectrum (while not in itself a taking of any property right of Taxpayer in the license or spectrum) necessitates the removal and replacement of the existing BAS equipment. This circumstance constitutes an involuntary conversion of Taxpayer's equipment. When, as here, the FCC requires a broadcaster to discontinue use of its own equipment, rendering such equipment useless for any purpose, and provides for functionally comparable non-interfering replacement equipment for the broadcaster, the previously-used equipment has been converted into similar property.

B. Was the condemnation or requisition for a public purpose?

The FCC's "clearing" of the BAS equipment and provision of comparable equipment for efficient, uninterrupted BAS service, as part of a larger project intended to promote the general public good, is a taking for a "public use" under Section 1033. In fact, since the FCC is charged by Congress with acting to promote the fair use of spectrum in the public interest, all its actions are presumptively undertaken in furtherance of that public purpose. In addition, and more specifically, the particular public use driving the reallocation of spectrum is the enhancement of the communications abilities of the nation's public safety first responders. Further, the FCC sought to ensure the continuity of BAS with minimal disruption to television broadcast services to the public because BAS is a part of the broadcast system by which emergency information is provided to the American public. Such a condemnation for the advancement of public purposes is analogous to the type of "public use" described by the Supreme Court in Kelo as required in a Fifth Amendment taking.

As part of the spectrum reallocation plan, Taxpayer 's existing BAS equipment is required to be taken out of service to prevent interference with new users of part of the spectrum formerly licensed to Taxpayer (1990 MHz-2025 MHz). This equipment will most likely be scrapped upon its transfer to Corporation-Z to guard against future interference. The Kelo case makes clear that the concept of public purpose is to be defined broadly with proper deference to the legislative or agency judgment implementing such public purpose. The Court explained that "[f]or more than a century, our public use jurisprudence has widely eschewed rigid formulas and intrusive scrutiny in favor of affording legislatures broad latitude in determining what public needs justify the use of the takings power." Kelo at 2664.

Through the Act, Congress delegated plenary powers to the FCC to regulate use of the public spectrum. The Court in Kelo stated that "once the question of the public purpose has been decided, the amount and character of the land to be taken for the project and the need for a particular tract to complete the integrated plan rests in the discretion of the legislative branch." Id. at 2668, citing Berman at 35-36. Here, since the FCC's purpose in regulating the spectrum, eliminating interference for public safety users, and ensuring the continuation of BAS is clearly for the public benefit, the particular details of implementation of this mandate is within the FCC's purview and discretion. The plan for reallocation of spectrum is for the advancement of a public purpose, both for Fifth Amendment and Section 1033 purposes.

C. Was the replacement property similar or related in service or use to the converted property?

Taxpayer will receive replacement equipment which will enable it to continue operations without interruption and with "comparable functionality" on the remaining licensed bandwidth. Pursuant to the FCC Order, Corporation-Z must provide the broadcasters with "comparable facilities." Comparable facilities are those that will provide the same level of service as the incumbent's existing facilities, with transition to the new facilities as transparent as possible to the public end users of the broadcast services. Specifically, the BAS replacement equipment must provide all the following elements of comparability: (1) equivalent channel capacity (both in the number of channels and in operational ability on the narrower bands); (2) equivalent signaling capability, baud rate, and access time; (3) coextensive geographic coverage; and (4) equivalent operating costs.

"[It] is not necessary to acquire property which duplicates exactly that which was converted." Maloof at 269, citing Loco Realty Co. v. Commissioner, supra. Thus, the fact that the new equipment may be more valuable, or may employ more efficient circuitry than the converted equipment (in that it uses digital rather than analog circuitry) does not matter for purposes of Section 1033(a)(1). Since all that Section 1033 requires is "a reasonable degree of continuity in the nature of the assets as well as in the general character of the business," the replacement equipment received by Taxpayer will be similar or related in service or use to that rendered worthless by the FCC action. Id. at 271. The FCC's reallocation plan requires the new

equipment provided to Taxpayer to be equivalent in functionality. This requires comparable ENG operations on seven BAS operating channels, each of which is approximately 5 MHz narrower than the channels on which Taxpayer currently operates. The independent transition administrator appointed by the FCC and Corporation-Z's own financial self-interest assure that the equipment provided will be neither more nor less than necessary to provide Taxpayer with "comparable facilities." In addition, Taxpayer, an owner-user of the converted equipment, will continue to be an owner-user rather than an owner-lessor, of the replacement equipment. Therefore, the replacement equipment is similar or related in service or use to the converted equipment.

In summary, the FCC has implemented a spectrum reallocation plan to improve the communications capabilities of the nation's public safety first responders. Under this plan, incumbent BAS broadcasters, including Taxpayer, must relocate to different and narrower frequency assignments. Such relocation necessitates, and the FCC Order requires, Taxpayer to cease using certain of its existing equipment, the use of which would otherwise cause interference with the new users of the reallocated and relicensed spectrum, and renders that equipment useless. Pursuant to the FCC Order, Taxpayer will be provided with "comparable facilities," that is, replacement equipment that will allow Taxpayer to continue its operations, primarily ENG, on the new and narrower spectrum licensed to it. Under the plan, the cost will be borne initially by Corporation-Z and ultimately by the FCC/US Treasury. This mandated replacement to facilitate the plan is an involuntary conversion within the provisions of Section 1033(a)(1) and non-recognition of gain is mandatory under Section 1.1033(a)- 2(b).

RULINGS

1. Taxpayer's exchange of its current BAS equipment for newly installed and tested equipment supplied by Corporation-Z pursuant to the FCC Order is an involuntary conversion of property into property similar or related in service or use to the property so converted under Section 1033(a)(1).

2. Taxpayer will not recognize gain on the exchange.

DISCLAIMERS AND LIMITATIONS

Except as 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 taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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. A copy of this letter must be attached to any income tax return to which it is relevant.

Enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under Section 6110.

Sincerely,

Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)
This document may not be used or cited as precedent.

General Counsel Memorandum 39182

Internal Revenue Service (I.R.S.)
General Counsel Memorandum (G.C.M.)
Date Numbered: March 6, 1984
October 6, 1982

Section 118 -- Contributions to the Capital of a Corporation
Section 1033 -- Involuntary Conversion

IN RE: WHETHER A TAXPAYER'S RIGHT TO THE EXCLUSIVE USE OF ITS RAILROAD TRACK IS 'PROPERTY' UNDER SECTION 1033. WHETHER INVOLUNTARY IMPROVEMENTS TO THE TRACK TO HANDLE ADDITIONAL TRAFFIC QUALIFY AS REPLACEMENT PROPERTY

TO: GERALD G. PORTNEY
Associate Chief Counsel (Technical)
Attention: Director, Corporation Tax Division

The Corporation Tax Division, in a memorandum dated March 9, 1982, requested our consideration of a ruling request in the above-named case

ISSUES

1.Whether the taxpayer's right to exclusive use of its railroad track is 'property' within the meaning of I.R.C. section 1033.

2.Whether involuntary improvements to the same track, to handle additional traffic, qualify as 'replacement property' under section 1033.

CONCLUSION

You have tentatively concluded that a taking of the taxpayer's exclusive right to use of railroad track is not 'property' within the meaning of section 1033 because the taxpayer has not parted with any of its income producing track and may in fact gain rental income, offset to some extent by increased maintenance costs. You have further concluded that involuntary improvements to the same track to handle additional traffic do not qualify as replacement property under section 1033, although you note that the taxpayer appears to meet the spirit of section 1033 and fails only on the formal requirements of the section.

We disagree with your conclusion that the taxpayer does not meet the requirements for the deferral of recognition of gain under section 1033. We find both that the taxpayer has suffered a taking of property within the meaning of section 1033 and that the investment of damages paid by the state in improvements to the track in the manner described will constitute an investment in replacement property that meets the requirements of section 1033.

You indicate that you have not considered the application of section 118 and that the administrative section handling this ruling would not consider a section 118 question. You have further indicated that both the taxpayer and the state resist consideration under this section. We have, therefore, limited our consideration to the two issues set forth in your memorandum.

FACTS

In order to build an interstate highway, the State of * * * proposes to displace the * * * railroad (not the taxpayer) from its yard and build the highway through the spot now occupied by the yard. * * * under threat of condemnation, intends to obtain a 'joint use agreement' permitting the displaced railroad to share use of 12 to 16 miles of the taxpayer railroad's track * * *. The taxpayer has submitted a statement from the Attorney General's office for the State of * * * indicating its belief that the state has the power, under case law and statute, to effect such a condemnation of railroad property in * * * through the exercise of its powers of eminent domain. The taxpayer further asserts that it has been notified by counsel for the state department of transportation that in the event of the taxpayer's failure to agree to joint use with * * *, the state would commence eminent domain proceedings.

The taxpayer currently has exclusive rights to use its track from * * * to * * * passing through * * *. It uses these rails to haul * * * and * * * to * * *. The track is light weight rail sufficient for the taxpayer's purposes. In order to adapt the * * * track for joint use, heavier track must be laid, improved signals placed, centralized traffic control installed and banking done to accommodate the longer heavier cars used by * * *.

Under the joint use agreement, the taxpayer would grant * * * a non-exclusive permanent easement on the track in question. The taxpayer would continue to own the track and would pay for increased maintenance but would receive a rental fee from * * * which would include, but not be limited to, its proportionate share of operation and maintenance costs. * * * would pay the costs for initial improvements, construction of the yard and necessary track improvements. However, the upgrading of the track, while paid for by * * * would be done by taxpayer with its own employees. Taxpayer would also receive a small overpass presently owned by the State of * * * and suitable for snowmobile use. The overpass would enable the taxpayer to conform to a * * * recreation law requiring that snowmobiles must be given access to a means of crossing railroad tracks at designated mileage intervals. The overpass could not be used for any other purpose.

As a result of joint use, the * * * would run approximately * * * cars out and back on a daily basis. [FN3] The first train on the track, whether the taxpayer's or * * * would have the right of way. Furthermore, the taxpayer would be required in perpetuity to maintain the track and to obtain permission from the displaced railroad before selling or abandoning the track.

As part of the proposed plan, the State of * * * intends to build a replacement railroad yard for * * * on * * * acres of land adjacent to the tract in * * *. The taxpayer owns approximately * * * acres of the land affected and is not presently using the acreage. The State of * * * has indicated that in order to implement their plans, ownership of the land must be transferred to * * * in return for a payment equivalent to the fair market value of the land.
The State of * * * indicated in conference that it would be relying on federal funds and that it believes it is therefore limited to the payment of relocation expenses and that it cannot make a capital contribution to a railroad.

LAW

Section 61(a) provides that, in general, except as otherwise provided in this subtitle, gross income means all income from whatever source derived.

Section 1033(a) provides that if property, as a result of its destruction in whole or in part, is compulsorily or involuntarily converted into property similar or related in service or use to the property converted, no gain will be recognized. When the property is converted into money, the gain shall be recognized except as provided in section 1033(a)(2)(A).

Section 1033(a)(2)(A) provides that if, during a specified period, the taxpayer purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized exceeds the cost of such other property. Similarly, Treas. Reg. section 1.1033(a)-2(c) provides that if property, as a result of its destruction in whole or in part, is involuntarily converted into money, any gain shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of the replacement property, if such property is similar or related in service or use to the property so converted.

In addition, with respect to real property held for productive use in trade or business, section 1033(g) provides that for the purposes of subsection (a), when such real property is compulsorily or involuntarily converted, property of a like kind to be held for productive use in trade or business or for investment will be treated as property similar or related in service or use to the property so converted.

ANALYSIS

I. AVAILABILITY OF NONRECOGNITION OF GAIN UNDER SECTION 1033

A. The * * * Land--Requirement for Threat or Imminence of Condemnation

Neither the taxpayer's briefs nor the presentation of issues by your division raise questions with respect to the * * * land. We assume this is a result of the fact that the land, if taken or sold under threat of condemnation, is clearly property within the meaning of section 1033 and the fact that we have no information about the replacement property, if any, in which the amount received for the land will be invested.

For both of these presumed reasons, we have limited our response in the remainder of the G.C.M. to the section 1033 issues raised with respect to the involuntary conversion of the taxpayer's right to exclusive use of a portion of its railroad track. We do note, however, that the applicability of section 1033 deferral of recognition of gain on the * * * land will require an initial determination that any sale was made under threat of condemnation.

The use of the term 'threat' is indicative of the fact that the statute does not require the possibility of condemnation to be reduced to a certainty. See S. & B. Realty Company v. Commissioner, 54 T.C. 863 (1970), acq., 1970-2 C.B. XX1; Rev. Rul. 81- 180, 1981-2 C.B. 66; Rev. Rul. 63-221, 1963-2 C.B. 332; Rev. Rul. 58-557, 1958-2 C.B. 402.

Both revenue rulings 58-577 and 63-221 were modified and expanded by Rev. Rul. 74-8, 1974-1 C.B. 200, considered in G.C.M. 35249 (Supp.), * * *, I-4900 (May 11, 1973), to provide that a threat or imminence of condemnation may also exist for purposes of section 1033 even if the named condemning authority does not have actual authority to condemn property for public use prior to or at the time of sale, if the named condemning authority could readily obtain such authority in the event that a voluntary sale is not arranged. In Rev. Rul. 74-8 the sale was to a public utility that, generally, could readily obtain the power to condemn by application to the appropriate state official. The ruling notes that there was no reason to believe that such power to condemn would be denied. G.C.M. 35249 (Supp.), supra., states this rule is inapplicable if the taxpayer has, or reasonably should have, knowledge that this power to condemn cannot be readily obtained.

In the present case, while * * * has no power to effect a condemnation of land in * * * through the exercise of its power of eminent domain, it has indicated that it will, if necessary, petition the United States Secretary of Commerce to acquire the * * * land under its statutory powers of condemnation and eminent domain. The power vested in the Secretary arises from title 23, U.S. Code section 107, which provides, in pertinent part, that when a state is unable to acquire lands or interest in lands necessary for purposes connected with the prosecution of any project for the construction of any section of the Interstate Highway System, the state may make application to the U.S. Secretary requesting that he acquire the needed property in the name of the United States by purchase, donation, condemnation or otherwise.

We believe that the rationale in G.C.M. 35249 (Supp.) and Rev. Rul. 74-8 can reasonably be extended to a situation in which the threatening party cannot itself obtain the power to take by condemnation but does have statutory authority to request that another government entity, endowed with such statutory authority, proceed to take the land under its powers of condemnation. However, this result would not apply, unless the taxpayer could evidence that, generally, the threatening party would be able to cause the entity empowered to condemn to exercise its power and that the taxpayer reasonably believed that this invoking of the power to condemn would be successful. We do not have sufficient facts at the present time to determine the State's likelihood of success should it request the U.S. Secretary of Commerce to act. Should the taxpayer sell the * * * land and reinvest the gain in replacement property that meets the requirements of section 1033 a determination of the existence or nonexistence of a threat should be made consistent with the test set forth here.

B. Whether Right of Exclusive Use is Property Within the Meaning of Section 1033

The taxpayer has asserted that under the proposed state plan it would lose its exclusive right to use of about * * * miles of its track . In addition, some of the taxpayer's light duty track would be modified to accommodate heavier longer cars used by * * *. The Corporation Tax Division has stated, and the taxpayer's briefs suggest, that the primary loss is that of loss of exclusive use of the line by virtue of granting to * * * a non-exclusive leasehold interest, in perpetuity, in the designated portion of taxpayer's track, subject to an obligation imposed on * * * to pay rental fees (including but not limited to its proportionate share of operation and maintenance costs).

The involuntary relationship between the taxpayer and * * * has characteristics present in both easements and leaseholds. In * * * G.C.M. 35491, I-5082 (September 24, 1973), the similarities between these two types of property interests [FN5] are acknowledged.

An easement is a nonpossessory interest that allows the owner of the property to continue to use the property for his or her purposes, subject to those limitations necessary to avoid infringement of the grant of rights contained in the easement.

The Restatement, Property (1944), in defining an provides that:

An easement consists in a privilege on the part of the person entitled to it to make some use of land subject to it. It must, in some way, limit the use of the property which the possessor of the subject land might otherwise make. It must, in addition to this, be in itself a property right, a right protected not merely against the possessor of the land subject to it but also against others. It must consist of such privileges of use as taken collectively are by accustomed habit deemed capable of creation by conveyance and must have the quality of being incapable of termination at the will of the possessor of the land subject to it. Id. section 8.5 at 232.

The joint-use agreement in this case manifests these characteristics. It consists of a privilege on the part of * * * to make use of the track belonging to the taxpayer. It likewise limits the use that the taxpayer can make of that track. The right granted to * * * is in perpetuity and thus protected againt infringement by the taxpayer, as well as by others. Furthermore, the agreement grants a non-exclusive right of use of a type that can be created by conveyance and it cannot be terminated at the will of the taxpayer.

In duration, the present arrangement is distinguishable from typical possessory interests created by leases, the characteristics of which generally include exclusive possession by the lessee, enforceable against the lessor, for a defined period (usually a term of years). See Nay v. Commissioner 19 T.C. 114, 119 (1952); Wineberg v. Commissioner, T.C.M. 1961-336, aff'd 326 F.2d 157 (9th Cir. 1963); TCR 15, 892, GCM 38046, I-477-78 (August 13, 1979). The agreement in the present case is not for a defined period, but rather for perpetual, intermittent use of the taxpayer's track. The agreement creates a permanent restriction on the taxpayer's use of its track; the taxpayer cannot sell or abandon the track without permission of DWP, which then has a first refusal right of purchase. We do not find that the present arrangement ceases to be an easement simply because the * * * will pay a fee of * * * per car using the line, as its share of maintenance costs.

Based on the factors considered in the foregoing discussion, the present situation should be treated as the involuntary creation of an easement, analogous to the situation discussed in Rev. Rul. 72-433, 1972-2 C.B. 470, considered in * * *, G.C.M. 34661, I-4104 (November 1, 1971 and May 11, 1972).

The Board of Tax appeals in Piedmont Mt. Airy-Guano Co., 3 B.T.A. 1009 (1926), acq., V-2 C.B. 3, (1926), acq. withdrawn, nonacq. substituted, x-1 C.B. 89 (1931), nonacq. withdrawn, acq. substituted, 1942-2 C.B. 15, held that the right to use and occupy a particular premises is a property right. The Piedmont court determined that use and occupancy is a property right inherent in the ownership of physical property and when such property is destroyed by fire, the portion of use and occupancy insurance that is immediately used in replacing such property in a condition fit for use and occupancy may be excluded from gain under section 234(a)(14) of the 1929 Revenue Act (now section 1033(a)). The decision and the acquiescence in Piedmont thus imply that section 1033 may be applicable when there is deprivation of use.

A subsequent revenue ruling, Rev. Rul. 38, 1953-1 C.B. 16, considered by this office in * * *, A-479865 (November 25, 1952), seemed to reach a conflicting result. The revenue ruling held that condemnation proceedings employed in the United States Government's acquisition of the use of a taxpayer's warehouse for a term of five years did not result in recognition of the compensation paid to the taxpayer as a gain from the involuntary conversion of property deferrable under section 112(f) of the 1939 Code (now section 1033). The ruling states that the taxpayer disposed of no property and that the compensation constitutes rental remuneration for use pursuant to the leasehold interest in the property acquired by the government. This result and the inherent conflict with Piedmont Mt. Airy-Guano Company, supra., were reconsidered by our office in G.C.M. 35767, * * * I-369-73 (April 4, 1974), and we recommended that Rev. Rul. 38 be modified to reflect a position that the lease granted to the United States Government is property for purposes of section 1033.

Arguably, a modification of Rev. Rul. 38 was effectuated in Revenue Ruling 72-433, 1972-2 C.B. 470, considered in G.C.M. 34661, * * *, I-4104 (November 1, 1971 and May 11, 1972).There, it is held that to the extent that the proceeds of an award resulting from the involuntary grant of an easement of flowage with some beneficial use of the land retained by taxpayer are invested to replace the property involuntariy converted (that is, to restore the volume of production to its former level), the taxpayers may utilize the provisions of section 1033 to defer the recognition of gain. The property subject to the easement was farmland. As a result of the flowage easement, use was restricted in two respects. First, the taxpayer could never build on the land and second, it was anticipated that farming activity would be hampered or prevented by flood waters once every 6 years.

In holding that section 1033 was applicable, G.C.M. 34661 notes that the grant of an easement that deprives the grantor of virtually all beneficial use of the servient parcel, leaving the taxpayer with mere legal title, is tantamount to a sale of the servient parcel. Scales v. Commissioner, 10 B.T.A. 1024, acq. 1, VII-2 C.B. 35 (1928). See also Rev. Rul. 54-575, 1954-2 C.B. 145, considered in * * *, A-610536 (April 15, 1954) (recognition of gain may be deferred under section 1033 when grant of an air-rights easement under threat of condemnation renders portions of farm virtually unusable); Rev. Rul. 56-436, 1956-2 C.B. 520, considered in G.C.M. 29400, * * *, A-617181 (April 5, 1956) (section 1033 deferral applicable to damages when flooding by a dam project with a surface easement caused the destruction in whole or in part of the taxpayer's retained mineral estates); G.C.M. 33777, Right-of-Way Easement Grants, I-2921 (March 25, 1968) (stating generally that Rev. Rul. 54-575 and Scales provide that if the grant of an easement deprives

the taxpayer of practically all the beneficial interest in his land except for the retention of mere legal title, the transaction is considered to be a sale of the land covered by the easements).

Both Rev. Rul. 72-433 and the underlying G.C.M. draw an analogy, for purposes of section 1033, between condemnation awards paid for easements and severance damages that are paid with respect to retained property. [FN6] Noting that both types of payment reimburse the owner for a diminution in the value of land to which he retains title, the G.C.M. concludes that the treatment of the reimbursement proceeds ought to be the same for tax purposes. Both the revenue ruling and the G.C.M. cite, for support, Rev. Rul. 69-240, 1969-1 C.B. 199, in which the taxpayer was permitted to defer recognition of gain under section 1033 for both the condemnation award and severance damages received when the taxpayer's farm was bisected by a highway. In light of this and the perceived similarity in purpose and effect of proceeds from easements and severance damages, the G.C.M. concludes, and Rev. Rul. 72-433 holds, that Rev. Rul. 54-575 is incorrect to the extent that it limits applicability of section 1033 to situations in which a taxpayer is deprived of 'practically all the beneficial interest' of property subject to an involuntarily granted easement.

The extent to which the grant of a perpetual flowage easement deprived the taxpayer in Rev. Rul. 72-433 of his beneficial rights in the land is not readily apparent from the facts. It is possible on the facts that the land was rendered substantially less valuable as farmland due to the periodic flooding and resultant changes in soil quality and prohibition against any facility for human habitation. If the facts of Rev. Rul. 72-433 are so interpreted, it may be contended that while the revenue ruling modifies Rev. Rul. 54-575, supra, to the extent that it holds the application of section 1033 is limited to a situation in which the taxpayer is deprived of practically all his beneficial rights in property, it does so only to a limited extent and still requires a substantial loss of availability or of beneficial use or rights before section 1033 is applicable.

We believe that this restrictive interpretation of the revenue ruling is inappropriate. Section 1033 has been interpreted as a relief provision and as such should be construed liberally to give effect to congressional intent. Paul Haberland, 25 B.T.A. 1370, 1378 (1932); Washington Markets Co., 25 B.T.A. 576, 584 (1932); John Richard Corp. v. Commissioner, 46 T.C. 41, 44 (1966); S & B Realty Co. v. Commissioner, 54 T.C. 863, 870 (1970) acq., 1970-2 C.B. XXI. Neither the statutory language nor the accompanying regulations compel a result that restricts the applicability of section 1033 to taxpayers whose property rights have been substantially diminished by involuntary conversion. Furthermore, so restrictive an interpretation is not supported by the purpose of section 1033.

The purpose of section 1033 was to allow taxpayers who have lost property under certain circumstances outside their control to invest the proceeds therefrom, undiminished by tax on the gain, in qualified replacement property, thus restoring themselves, in so far as possible, to their position prior to the involuntary conversion. In S. H. Kress and Co. v. Commissioner, 40 T.C. 142, 153 (1963), the Tax Court stated that the basic purpose of section 1033 is to allow the taxpayer to replace his property without realization of gain 'where he is compelled to give up such property because of circumstances beyond his control.' See also S. E. Ponticos Inc. v. Commissioner, 40 T.C. 60, 64 (1963). In C. G. Willis, Inc. v. Commissioner, 41 T.C. 468, 476 (1964), the Tax Court stated that 'Involuntary conversation within the meaning of section 1033(a) means that the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes.'

In the present case, it appears from the facts, that if the state were to force the taxpayer to permit * * * to use the present track without modification, the track would, in all probability, soon be rendered unavailable and useless. Furthermore, the taxpayer has asserted in its supplemental submission, dated * * * that the State of * * * has acknowledged that the re-routing of * * * traffic over taxpayer's right-of-way has diminished the usefulness of taxpayer's remaining facilities. These harms seem to be primarily the loss of flexibility, possible delays in traffic flow and potential maintenance and managerial costs. The taxpayer has also stated that the resultant restrictions on its free use of track and on the ways in which it could alter its track and service in the future may damage its ability to compete for business.

The present case is analogous to the payment of severance damages on the same theory as the flowage easement situation discussed in G.C.M .34661 (Supp.) supra. In each case, the taxpayer has experienced an involuntary conversion of a property interest in land to which he retains title. In each, he is compensated with an amount determined on the basis of anticipated damages flowing from the diminution in the usefulness of the property to him. In the present case, the evidence presented indicates that use of taxpayer's track by * * * without the required improvements would impair and perhaps destroy the usefulness of the track to the taxpayer, who would then be obliged to repair or rebuild the track to restore its usefulness to him. This anticipated repair and restoration expenditure is essentially what the state is paying the taxpayer as damages through the mechanism of modifying the track now.

As discussed, treating the condemnation proceeds in a manner analogous to the payment of severance damages and determining that section 1033 is applicable, is consistent with both the purpose of section 1033 and the position set forth in Rev. Rul. 72-433.

C. Reinvestment Requirement

Availability of section 1033(a) deferral of recognition of gain is conditioned on reinvestment of the gain in replacement property that is similar or related in service or use to the property converted. Section 1033(a)(2)(A). The Service has historically applied a 'functional use' test in defining this requirement. The test holds that property is similar or related in service or use if the physical characteristics and end uses of the converted and replacement properties are closely similar. This 'functional use' test, as applied to owner-users of property, was affirmed in Rev. Rul. 64-237, 1964-2 C.B. 319.

The reinvestment standard is essentially the same with respect to severance damages otherwise qualifying under section 1033(a). Here the reinvestment must restore the usability of the retained property in order to qualify for deferral within the mandates of the 'similar or related in service or use ' test. Thus, restoration of usability need not be to the exact same use but must be to a similar or related use. G.C.M. 38256, * * *, supra.

In the subject case, the taxpayer operated the track as it existed prior to the condemnation. He will continue to operate the track after the involuntary improvements are made. The replacement property is similar or related in service or use. [FN8] The fact that as a result of the forced easement for joint use heavier, more sophisticated and perhaps more valuable track is required to restore the taxpayer to its prior level of use does not cause the

reinvestment to fail the similar or related in use test. The improvements will merely permit taxpayer to continue to use the track as it had done before the forced grant of a permanent easement for use by * * *.

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This document is not to be relied upon or otherwise cited as precedent by taxpayers.

UNITED STATES TAX REPORTER P 1684.045

Internal Revenue Service (I.R.S.)
United States Tax Reporter (USTR)

P 1684.045 Depreciation of MACRS property acquired or relinquished in a like-kind exchange or involuntary conversion — overview.

Regs, explained at P 1684.046 et seq., provide rules for determining the depreciation allowance for MACRS property acquired in a like-kind exchange or an involuntary conversion, including a like-kind exchange or an involuntary conversion of MACRS property that is exchanged or replaced with other MACRS property in a transaction between members of the same affiliated group (see P 15,024.17) of corporations. Treas. Reg. Section 1.168(i)-6(a). These regs also provide rules for determining the depreciation, in the year of disposition, of property relinquished in a like-kind exchange or involuntary conversion. Treas. Reg. Section 1.168(i)-6(c)(5)(i).

No depreciation deduction is allowable for MACRS property disposed of by a taxpayer in a like-kind exchange or involuntary conversion in the same tax year that the property was placed in service by the taxpayer. Treas. Reg. Section 1.168(i)-6(c)(5). If replacement MACRS property (see Treas. Reg. Section 1.168(i)-6(b)(1)) is disposed of by a taxpayer during the same tax year that the relinquished MACRS property (see Treas. Reg. Section 1.168(i)-6(b)(2)) is placed in service by the taxpayer, no depreciation deduction is allowable for either MACRS property. Treas. Reg. Section 1.168(i)-6(c)(5).

For the depreciation of passenger automobiles involved in a like-kind exchange or involuntary conversion, see P 1684.047. For how additional first-year depreciation (bonus depreciation) applies to MACRS property, or computer software, involved in a like-kind exchange or involuntary conversion, see P 1684.048. For an election not to apply the regs explained above, see P 1684.049.

Property covered by the regs. If both MACRS and nondepreciable property are acquired in a like-kind exchange for, or as part of an involuntary conversion of, MACRS property, the basis allocated to the nondepreciable property — as determined under IRC Section 1031(d) (see P 10,314.13) or IRC Section 1033(b) (see P 10,334.33) (and the regs under those Code sections) — isn't depreciated. However, the basis allocated to the replacement MACRS property is depreciated in accordance with the regs explained at P 1684.046 et seq. Treas. Reg. Section 1.168(i)-6(d)(2)(i).
If MACRS property is acquired, or if both MACRS and nondepreciable property are acquired, in a like-kind exchange for, or as part of an involuntary conversion of, land or other nondepreciable property, the basis in the replacement MACRS property that is attributable to the relinquished nondepreciable property is treated as though the replacement MACRS property is placed in service by the acquiring taxpayer in the year of replacement. Thus, the depreciation allowances for the replacement MACRS property are determined by using the applicable recovery period, depreciation method, and convention prescribed by the MACRS rules for the replacement MACRS property at the time of replacement. Treas. Reg. Section 1.168(i)-6(d)(2)(ii).

Observation: In other words, to the extent that, in a like-kind exchange or involuntary conversion, MACRS property replaces nondepreciable property, the MACRS property is depreciated under the 'regular' MACRS rules (P 1684 et seq.), instead of under the regs explained at P 1684.046 et seq.

Also, property acquired in a like-kind exchange or involuntary conversion to replace property whose depreciation allowance is computed under a depreciation system other than MACRS, or to replace property for which a taxpayer made a valid election to exclude it from MACRS (see P 1684), is not covered by the regs explained at P L-1684.046 et seq. Preamble TO TD 9115, 2/27/2004. For an election that applies to certain property replacing property that a taxpayer elected to exclude from MACRS, see P 1684.0481.

The regs don't provide guidance for a taxpayer acquiring property in an exchange for property that the taxpayer depreciated under ACRS (see P 1688.400 et seq.) or for a taxpayer acquiring an automobile for another automobile for which the taxpayer used the Standard Mileage Rate method of deducting expenses (see P 1624.157). Preamble TO TD 9115, 2/27/2004.

Additionally, the regs don't apply to MACRS property to which the regs, explained at P 1684.06, concerning certain like-kind exchanges of tax-exempt-use property, apply. Treas. Reg. Section 1.168(i)-6(a).

Until further guidance is issued, taxpayers can apply the principles of the regs explained at P 1684.046 et seq. to determine the depreciation treatment of MACRS property acquired in multi-property transactions. Preamble TO TD 9115, 2/27/2004.

Effect of depreciation by previous owners.

The depreciation treatment of the replacement MACRS property by previous owners has no effect on the determination of depreciation allowances for the replacement MACRS property in the hands of the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property for property that was depreciated under ACRS by the previous owner must apply the regs explained at P 1684.046 et seq., because the replacement property will become MACRS property in the hands of the acquiring taxpayer. In addition, elections made by previous owners in determining depreciation allowances for the replacement MACRS property have no effect on the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property that the taxpayer depreciates under the general depreciation system for other MACRS property that the previous owner elected to depreciate under the alternative depreciation system (ADS) doesn't have to continue using the ADS for the replacement MACRS property. Treas. Reg. Section 1.168(i)-6(c)(2).
Code 179 expensing deduction.

In applying the expensing deduction under IRC Section 179 to replacement MACRS property, only the excess basis (see Treas. Reg. Section 1.168(i)-6(b)(8)), if any, in the replacement MACRS property is taken into account. This rule applies even if the replacement MACRS property is depreciable property that was acquired for nondepreciable property. Treas. Reg. Section 1.168(i)-6(g).

Prior law

For like-kind exchanges and involuntary conversions for which either the time of disposition or the time of replacement occurred before Feb. 28, 2004, a taxpayer was permitted to, but wasn't required to, apply the regs explained above. Treas. Reg. Section 1.168(i)-6(k)(1)(i); Treas. Reg. Section 1.168(i)-6(k)(2) ; Treas. Reg. Section 1.168(i)-6(k)(2)(i). Alternatively, a taxpayer could rely on earlier IRS guidance (for example, Notice 2000-4, explained below) for determining the depreciation deductions of replacement MACRS property or relinquished MACRS property involved in an exchange or conversion. In relying on that guidance, a taxpayer could use any reasonable method of determining depreciation in the year of disposition and the year of replacement. Treas. Reg. Section 1.168(i)-6(k)(2)(ii).

If a taxpayer filed its income tax return before Feb. 28, 2004, and the taxpayer had treated the replacement MACRS property as acquired, and the relinquished MACRS property as disposed of, in a like-kind exchange or involuntary conversion, the taxpayer could change its method of accounting for the depreciation of the replacement MACRS property and relinquished MACRS property in accordance with the provisions of the regs explained above, or in accordance with earlier IRS guidance, by following prescribed IRS procedures for changing accounting methods. For further guidance, see P 4464.227. Treas. Reg. Section 1.168(i)-1(k)(2)(i); Treas. Reg. Section 1.168(i)- 6(k)(2)(ii).

For relinquishments or acquisitions of MACRS property, in a like-kind exchange or involuntary conversion, before Feb. 28, 2004 and after Jan, 2, 2000, taxpayers could rely on Notice 2000-4. Preamble TO TD 9115, 2/27/2004.

Notice 2000-4 provided that MACRS property that was acquired for MACRS property in a like-kind property exchange to which IRC Section 1031 applies, or in replacement of involuntarily converted MACRS property in an involuntary conversion to which IRC Section 1033 applies, was depreciated in the same manner as the exchanged or involuntarily converted property for the portion of the taxpayer's basis in the acquired property that didn't exceed the taxpayer's adjusted basis in the exchanged or involuntarily converted property. Thus, the acquired MACRS property was depreciated over the remaining recovery period of the exchanged or converted MACRS property, using the same depreciation method and convention as that of the exchanged or converted MACRS property. However, any excess of the basis in the acquired MACRS property over the adjusted basis in the exchanged or converted MACRS property was treated as newly purchased MACRS property. Notice 2000-4, 2000-1 CB 313 before obsoleted by Treas Dec 9115, 2/27/2004.

For the procedure which had to be followed if, for the first or second tax year ending after Jan. 3, 2000, a taxpayer was to receive consent to change from depreciating MACRS property acquired in a like-kind exchange or involuntary conversion as newly purchased property to depreciating the property under the above rules, see P 4464.225.

For MACRS property placed in service before Jan. 3, 2000, a taxpayer wasn't required to follow Notice 2000-4. Instead, the IRS allowed taxpayers to continue to use their present method of depreciating the acquired MACRS property, and the IRS treated that method as an allowable method of depreciation. Thus, taxpayers that were depreciating MACRS property placed in service before Jan. 3, 2000 either (1) under rules similar to those in Notice 2000-4, (consistent with Prop Reg Section 1.168-5(f)) or (2) as newly purchased property, could continue to do so. Notice 2000-4, 2000-1 CB 313 before obsoleted by Treas Dec 9115, 2/27/2004.

TAX OWNERSHIP

EXCHANGE ENTITIES (ARTICLE)

CONSIDER THESE VESTING ISSUES PRIOR TO A §1031 EXCHANGE

Generally in a §1031 tax deferred exchange, an Exchanger should take title to the replacement property in the same manner they held title on the relinquished property. In most cases, the entity initiating the exchange must be the same entity concluding the exchange. Some examples are reflected below:

- If a wife relinquishes, than the wife acquires;
- Smith LLC relinquishes, Smith LLC acquires;
- Gemco Corp. relinquishes, Gemco Corp. acquires;
- Durst Partnership relinquishes, Durst Partnership acquires.

SOME EXCEPTIONS TO THE GENERAL RULE

- Partnerships and Limited Liability Companies (LLC's): An Exchanger who elects taxation as a sole proprietorship can hold the relinquished property as an individual but acquire the replacement property as a single-member, single-asset LLC. This provides the benefit of liability protection and also can help satisfy the 'single asset entity' requirements that many lenders impose on replacement property purchases. The IRS has also ruled that a limited liability company with two members will be considered a single member limited liability company if the sole role of one of the members is to prevent the other member from placing the LLC into bankruptcy and that the limited role member had no interest in LLC profits or losses nor any management rights other than the limited right regarding bankruptcy.
- Grantor Trusts: An Exchanger can acquire a replacement property in a revocable living trust or "grantor" trust for estate planning purposes.
- Death of an Exchanger: If the Exchanger dies during the exchange, the Exchanger's estate may complete the exchange.

BUSINESS CONSIDERATION/LENDER REQUIREMENTS

Sometimes a business consideration, lender requirement or the Exchanger's liability issues can make it difficult to keep the vesting entity the same throughout the exchange. For this reason, it is important that Exchangers review the entire exchange transaction with their legal and/or tax advisors before closing on the sale of the relinquished property. Some problem areas:

If a wife, as the only Exchanger, is relying on the husband's income to qualify for replacement property financing, the lender may require that the husband appear on the deed. This could have an impact on the wife's exchange.

Most lenders are wary about lending to trustees. An Exchanger who relinquishes property in a trust but needs to obtain conventional financing for the purchase may have difficulty obtaining a loan because lenders prefer loaning to an individual.

Sometimes an Exchanger may relinquish a property in one entity such as multi-member LLC, corporation or partnership but want to acquire a replacement property in a different entity. This would disqualify the exchange.

§1031 EXCHANGES AND TAX OWNERSHIP (ARTICLE)

A common but often misunderstood principle among those familiar with tax deferred exchanges under Internal Revenue Code Section 1031 is the notion that the vesting of the replacement property acquired in the exchange must match the vesting of the property sold by the taxpayer. In other words, if title to the property relinquished in the exchange is in a corporation, then title to the replacement property must be acquired by the same corporation. Although the foregoing statement may be true in many cases, it is merely a guideline for structuring an exchange. What is required to complete an otherwise valid §1031 exchange is that the "tax owner" of the relinquished property must acquire tax ownership of replacement property within the exchange period permitted under §1031. Fortunately, there are many ways to acquire tax ownership of property that can involve the use of certain business entities or trusts that are disregarded for federal income tax purposes. Through the use of these entities in a tax deferred exchange, a wide variety of structuring opportunities become available, some of which can address an exchange clients other investment goals such as limited liability and succession planning. In these cases, the vesting of the relinquished property may be very different than the vesting of the replacement property, although tax ownership of the replacement property is the same both before and after the exchange.

To make sense of the proposition set forth above, it is necessary to distinguish between: (i) federal tax ownership, (ii) state law ownership, and (iii) vesting. In any given case, all three indicators of ownership might match up, such as an individual who holds title to investment property as "John Smith, an unmarried man". But even in this simple case, Mr. Smith might not actually own the property to which he holds title under state law or federal tax law. For example, many states recognize nominee arrangements under which Mr. Smith might hold title for the benefit of another person who actually owns the property. If there were such a nominee arrangement, Mr. Smith would be the record title holder, but not the tax owner or the state law owner of the property. If Mr. Smith sells property that he holds as nominee for Mr. Saunders, then the gain on the sale would be reported by Mr. Saunders.

Similarly, if title to property is held in the ABC limited liability company (ABC LLC), we know what vesting should look like and that the state law ownership rests in the limited liability company, but who is the tax owner? The answer depends on how ABC LLC is characterized for federal income tax purposes. If the company has elected to be taxed as a corporation, then tax ownership would be in the company. If the limited liability company has more than one member and has not elected to be treated as a corporation for tax purposes, then it is treated as a partnership for federal income tax purposes and, again, the company is the tax owner of the property. If, however, Mr. Smith is the sole member of ABC LLC and the company has not elected to be treated as a corporation for federal tax purposes, then Mr. Smith is the owner of the property for federal income tax purposes. Under federal tax law, a single member limited liability company is a "disregarded entity" and its assets are treated as owned by the sole member of the company. Thus, if Mr. Smith sells property in a § 1031 deferred exchange (property that was titled in his name), he could acquire property in ABC LLC provided that he is the sole member and the company is a disregarded entity. The same result would follow where ABC LLC sells relinquished property and Mr. Smith acquired replacement property in his individual name.

Revocable trusts are another area where tax ownership, state ownership and vesting may diverge. During the lifetime of the person who forms a revocable trust (a Grantor) and during the time he or she retains the right to revoke the trust, federal law treats the Grantor as the tax owner of assets held in the trust. So, as the Grantor, Mr. Smith is the tax owner of assets held is his revocable trust, but the trust is treated as an entity under state law and for purposes of vesting and ownership of trust property. Thus, Mr. Smith might sell property owned by his revocable trust as part of a tax deferred exchange and acquire replacement property in his own name. Alternatively, if Mr. Smith sells property owned by his trust, he could also acquire replacement property in a disregarded limited liability company in which he was the sole member, or, he could acquire replacement property in a disregarded limited liability company *owned solely by Mr. Smith's revocable trust*.

In most of the foregoing examples, a valid exchange can be accomplished in circumstances where the vesting of the relinquished property does not match the vesting of the replacement property, so the notion that vesting of the relinquished property and the replacement property must be the same is not a hard and fast rule. What matters is that the tax owner of the relinquished property acquires tax ownership of replacement property. The determination of tax ownership is not always a simple matter, especially for those not steeped in federal tax law, but accountants and tax attorneys can assist in structuring an exchange transaction to maximize the taxpayer's advantage. In the last example in the proceeding paragraph in which Mr. Smith relinquishes property owned in his revocable trust and acquires replacement property in a disregarded limited liability company owned solely by Mr. Smith's revocable trust, Mr. Smith not only obtained tax deferral under §1031, he obtained limited liability under state law that would protect the trust and himself from liabilities that might arise out of his ownership and operation of the property, and ensured that the property was properly held in his trust to be disposed of in accordance with his overall estate plan.

Asset Preservation, Inc. encourages clients to obtain competent tax and/or legal advice in structuring an exchange transaction. As an experienced qualified intermediary, we have seen a broad array of transactions that qualify as tax deferred exchanges under IRC §1031. However, because of the non-tax considerations surrounding the structure of an exchange transaction (such as limited liability, liability protection and succession planning), many exchange clients would benefit by consulting their personal tax and/or legal advisors before engaging in an exchange transaction.

NEW EXCHANGE INFORMATION SHEET – RELINQUISHED PROPERTY SALE

Estimated Close Date

Seller / Exchanger Information

As they are shown on title

Mailing Address

City | State | Zip

Phone | Phone 2 / Other

Fax | Email

Closer / Escrow Officer Information

Name | Company

Address

City | State | Zip

Phone | Fax

Email | File No.

Property Information

Address or Description:

City | State | Zip

County

Is the Property: ☐ Single/Multiple Family Residence ☐ Commercial ☐ Land ☐ Apt. Bldg. ☐ Other

Real Estate Agent / Broker

Name | Company | Phone

Buyer(s)

As they will be shown on title

Transaction Details

Sale Price $ | Estimated Mortgage Payoff $

Is there Seller financing? ☐ Yes ☐ No | If yes, amount? $

ADDITIONAL INFORMATION

Please send this form to Asset Preservation, Inc. by either:

Email

1) Go to FILE in the menu bar, select SEND MAIL
2) Address your email to: info@apiexchange.com
   Subject line: NEW ORDER. Please include your contact information

Fax

1) Complete and Print Form
2) Fax to API - Attn: NEW ORDER
   Please include your contact information

If you do not receive confirmation from us within 24 hours, please contact us immediately!

National Headquarters 800-282-1031 • 916-791-5991 • Fax: 916-749-1270
Eastern Regional Office 866-394-1031 • 631-369-3617 • Fax: 631-614-7954

NEW EXCHANGE INFORMATION SHEET – REPLACEMENT PROPERTY PURCHASE

Estimated Close Date

Buyer / Exchanger Information

As they will be shown on title

Mailing Address

City | State | Zip

Phone | Phone 2 / Other

Fax | Email

Closer / Escrow Officer Information

Name | Company

Address

City | State | Zip

Phone | Fax

Email | File No.

Property Information

Address or Description:

City | State | Zip

County

Is the Property: ☐ Single/Multiple Family Residence ☐ Commercial ☐ Land ☐ Apt. Bldg. ☐ Other

Real Estate Agent /Broker

Name | Company | Phone

Seller(s)

As they are shown on title

Transaction Details

Purchase Price $

Is a Deposit Needed? ☐ Yes ☐ No If yes, amount? $

ADDITIONAL INFORMATION

Please send this form to Asset Preservation, Inc. by either:

Email

1) Go to FILE in the menu bar, select SEND MAIL
2) Address your email to: info@apiexchange.com
   Subject line: NEW ORDER. Please include your contact information

Fax

1) Complete and Print Form
2) Fax to API - Attn: NEW ORDER
   Please include your contact information

If you do not receive confirmation from us within 24 hours, please contact us immediately!

National Headquarters 800-282-1031 • 916-791-5991 • Fax: 916-749-1270
Eastern Regional Office 866-394-1031 • 631-369-3617 • Fax: 631-614-7954

Form **8824**

Department of the Treasury
Internal Revenue Service

Like-Kind Exchanges

(and section 1043 conflict-of-interest sales)

▶ **Attach to your tax return.**

OMB No. 1545-1190

2007

Attachment Sequence No. **109**

Name(s) shown on tax return | **Identifying number**

Part I Information on the Like-Kind Exchange

Note: *If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.*

1 Description of like-kind property given up ▶

2 Description of like-kind property received ▶

3 Date like-kind property given up was originally acquired (month, day, year) . . . . . 3 / /

4 Date you actually transferred your property to other party (month, day, year) . . . . . 4 / /

5 Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written notice requirement . . . . . 5 / /

6 Date you actually received the like-kind property from other party (month, day, year). See instructions 6 / /

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . ☐ **Yes** ☐ **No**

Part II Related Party Exchange Information

8 Name of related party | Relationship to you | Related party's identifying number

Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party directly or indirectly (such as through an intermediary) sell or dispose of any part of the like-kind property received from you in the exchange? . . . . . ☐ **Yes** ☐ **No**

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? . . . . . ☐ **Yes** ☐ **No**

If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is ***not*** *the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24* ***unless*** *one of the exceptions on line 11 applies.*

11 If one of the exceptions below applies to the disposition, check the applicable box:

a ☐ The disposition was after the death of either of the related parties.

b ☐ The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.

c ☐ You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as its principal purpose. If this box is checked, attach an explanation (see instructions).

For Paperwork Reduction Act Notice, see page 5. Cat. No. 12311A Form **8824** (2007)

Name(s) shown on tax return. Do not enter name and social security number if shown on other side. | Your social security number

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: *If you transferred* ***and*** *received* ***(a)*** *more than one group of like-kind properties or* ***(b)*** *cash or other (not like-kind) property, see* **Reporting of multi-asset exchanges** *in the instructions.*

Note: *Complete lines 12 through 14* ***only*** *if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12	
13	Adjusted basis of other property given up	13	
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14	
	Caution: *If the property given up was used previously or partly as a home, see* **Property used as home** *in the instructions.*		
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions)	15	
16	FMV of like-kind property you received	16	
17	Add lines 15 and 16	17	
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15 (see instructions)	18	
19	**Realized gain or (loss).** Subtract line 18 from line 17	19	
20	Enter the smaller of line 15 or line 19, but not less than zero	20	
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions)	21	
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions)	22	
23	**Recognized gain.** Add lines 21 and 22	23	
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23	25	

Part IV Deferral of Gain From Section 1043 Conflict-of-Interest Sales

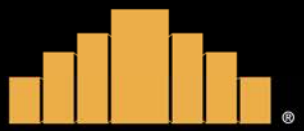
Note: *This part is to be used* ***only*** *by officers or employees of the executive branch of the Federal Government or judicial officers of the Federal Government for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used* ***only*** *if the cost of the replacement property is more than the basis of the divested property.*

26 Enter the number from the upper right corner of your certificate of divestiture. (**Do not** attach a copy of your certificate. Keep the certificate with your records.) ▶ _____ – _____

27 Description of divested property ▶ _____

28 Description of replacement property ▶ _____

29	Date divested property was sold (month, day, year)	29	/ /
30	Sales price of divested property (see instructions)	30	
31	Basis of divested property	31	
32	**Realized gain.** Subtract line 31 from line 30	32	
33	Cost of replacement property purchased within 60 days after date of sale	33	
34	Subtract line 33 from line 30. If zero or less, enter -0-	34	
35	Ordinary income under recapture rules. Enter here and on Form 4797, line 10 (see instructions)	35	
36	Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797 (see instructions)	36	
37	**Deferred gain.** Subtract the sum of lines 35 and 36 from line 32	37	
38	**Basis of replacement property.** Subtract line 37 from line 33	38	



ASSET PRESERVATION
INCORPORATED

A National IRC §1031 "Qualified Intermediary"

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