Related Party Like-Kind Exchanges: Teruya Brothers and Beyond

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The non-tax-avoidance exception of Section 1031(f) generally will be unavailable where the taxpayer defers tax through a related-party exchange and cannot establish that the related party will incur a higher “tax price.” Several planning approaches may be available, however, for taxpayers to achieve tax deferral.
At issue in the *Teruya Brothers* decisions was the application of Section 1031(f) to two exchanges involving Teruya Brothers, Ltd., and its related party, Times Super Market, Ltd., a C corporation of which Teruya Brothers owned 62.5% of the common stock.

Section 1031(f)(1) provides that if a taxpayer exchanges property with a related person\(^2\), the taxpayer does not recognize gain or loss because the transaction is treated as a like-kind exchange, and within two years of the last transfer either the taxpayer or the related person disposes of the property received in the exchange, then at the time of that second disposition the taxpayer's gain on the original exchange is triggered. Section 1031(f)(2) disregards certain types of second dispositions in determining compliance with Section 1031(f)(1):

- Any disposition after the earlier of the death of the taxpayer or the related person.
- Any disposition in an involuntary conversion within the meaning of Section 1033 if the exchange occurred before the threat or imminence of the conversion.
- Any disposition if it can be established to the Service's satisfaction that neither the exchange nor the disposition had federal income tax avoidance as one of its principal purposes.\(^3\)

The related-party provision also has its own specific anti-avoidance rule. Section 1031(f)(4) provides that Section 1031 will not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of Section 1031(f).

Section 1031(f) is aimed at preventing pre-sale basis shifting, which Congress considered abusive. As articulated in the legislative history, "[b]ecause 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-

\(^2\) For purposes of Section 1031(f), Section 1031(f)(3) provides that "related person" means any person bearing a relationship to the taxpayer described in Section 267(b) or 707(b)(1).

\(^3\) Several types of transactions that satisfy this category are specifically described in the legislative history of Section 1031(f). See H. Rep't No. 101-386, 101st Cong., 1st Sess. 614 (1989).
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 person 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.”

The Teruya-Times Exchanges

Teruya Brothers owned two rental properties, "Ocean Vista" and "Royal Towers." It entered into contracts to sell both these relinquished properties to unrelated parties, contingent on Teruya Brothers finding suitable replacement property that it could acquire as part of a Section 1031 exchange. Instead of looking to acquire the replacement property from unrelated parties, Teruya Brothers decided to acquire all of its replacement properties from its related party, Times, in two separate like-kind exchanges. Both of these occurred in 1995 and made use of a qualified intermediary (QI) as an exchange facilitator. Times and Teruya Brothers agreed on the values of the replacement properties Teruya Brothers was to acquire from Times.

Teruya Brothers acquired Kupuohi II (KII) from Times in exchange for Ocean Vista and $1.4 million cash. Immediately before the exchange, Ocean Vista had an FMV of $1.4 million, a tax basis in Teruya Brothers' hands of approximately $100,000, and thus an inherent gain to Teruya Brothers of $1.3 million. KII had an agreed FMV of $2.8 million, a tax basis in Times' hands of $1.5 million, and thus an inherent gain to Times of $1.3 million.

Teruya Brothers acquired Kupuohi I (KI) and Kaahumanu (K) from Times in exchange for Royal Towers and $700,000 in cash. Immediately before the exchange, Royal Towers had an FMV of $11.9 million, a tax basis in Teruya Brothers' hands of $700,000, and thus an inherent gain to Teruya Brothers of $11.2 million. K had an agreed FMV of $3.7 million, a tax basis in Times' hands of $1.5 million, and

thus an inherent gain to Times of $2.2 million. KI had an agreed FMV of $8.9 million, a tax basis in Times' hands of $15.6 million, and thus an inherent loss to Times of $6.7 million.

On its corporate tax return for the year ended 3/31/96, after taking into account its expenses, Teruya Brothers deferred gain of $1.3 million from the Ocean Vista transaction and $10.7 million from the Royal Towers transaction.

Times recognized its $3.5 million gain on the sale of K and KII (less expenses), but this gain recognition was offset by Times' NOLs and Times therefore paid no tax on this gain. Times realized approximately a $6.7 million loss (plus expenses) on the sale of KI. Times did not claim the $6.7 million loss on KI because of the Section 267(f)(2)(B) deferral on recognition of losses on sales to related corporations.

Exhibit 1 shows what occurred as a result of the two exchanges from the perspective of the "cash-out" abuse at which Section 1031(f) is targeted. In round numbers, the Teruya Brothers-Times group decreased its investment property position by $13.3 million ($28.7 million before less $15.4 million after), and equally increased its cash position by $13.3 million ($15.4 million after less $2.1 million before), as a result of the two exchanges. Despite this $13.3 million cash-out of property with a basis of $800,000, Teruya Brothers reported no gain recognition under Section 1031(a)(1), and Times reported that recognized gain of $3.5 million on Times' cash sale of KII and K to Teruya Brothers' QI was entirely offset by Times' NOLs.

Exhibit 1. Results of the Exchanges

Amounts are in millions of dollars, with certain simplifications due to rounding and expenses:

Property-Cash Position Before:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
<th>Unrealized Gain/(Loss)</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Teruya Brothers</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ocean Vista</td>
<td>$1.4</td>
<td>$0.1</td>
<td>$1.3</td>
<td></td>
</tr>
<tr>
<td>Royal Towers</td>
<td>$11.9</td>
<td>$0.7</td>
<td>$11.2</td>
<td></td>
</tr>
<tr>
<td>---------------</td>
<td>-------</td>
<td>------</td>
<td>-------</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$13.3</td>
<td>$0.8</td>
<td>$12.5</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Times</th>
<th>FMV</th>
<th>Basis</th>
<th>Unrealized Gain/(Loss)</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>KII</td>
<td>$2.8</td>
<td>$1.5</td>
<td>$1.3</td>
<td></td>
</tr>
<tr>
<td>K</td>
<td>$3.7</td>
<td>$1.5</td>
<td>$2.2</td>
<td></td>
</tr>
<tr>
<td>KI</td>
<td>$8.9</td>
<td>$15.6</td>
<td>($6.7)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$15.4</td>
<td>$18.6</td>
<td>($3.2)</td>
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</table>

Property-Cash Position After:

<table>
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<tr>
<th>Teruya</th>
<th>FMV</th>
<th>Basis</th>
<th>Unrealized Gain/(Loss)</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>KII</td>
<td>$2.8</td>
<td>$1.5</td>
<td>$1.3</td>
<td></td>
</tr>
<tr>
<td>K</td>
<td>$3.7</td>
<td>$0.4</td>
<td>$3.3</td>
<td></td>
</tr>
<tr>
<td>KI</td>
<td>$8.9</td>
<td>$1.0</td>
<td>$7.9</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$15.4</td>
<td>$2.9</td>
<td>$12.5</td>
<td>$0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Times</th>
<th>FMV</th>
<th>Basis</th>
<th>Unrealized Gain/(Loss)</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
<td>$15.4</td>
</tr>
</tbody>
</table>

1/The sum of the $93,000 basis in Ocean Vista plus $1,366,000 in cash paid to Times. This analysis assumes the two transactions would be treated as separate exchanges.

2/The sum of the $700,000 basis of Royal Towers plus $700,000 in cash paid to Times, multiplied by the fraction of $3.7 million (the FMV of K) over $12.6 million (the total FMV of K and KI).

3/The sum of the $700,000 basis of Royal Towers plus $700,000 in cash paid to Times multiplied by the fraction of $8.9 million (the FMV of K) over $12.6 million (the total FMV of K and KI).
Based on these facts, the Tax Court held that the exchanges were structured to avoid the purposes of Section 1031(f)(1) and so violated Section 1031(f)(4). The taxpayer appealed that decision to the Ninth Circuit.

**The Ninth Circuit**

Although the Ninth Circuit has often marched to the beat of its own drummer in Section 1031 cases, in *Teruya Brothers* the appellate court marched closely in step with the reasoning of the Tax Court in this case, and affirmed the decision without deviating from the analysis of the Tax Court.

The Ninth Circuit began its analysis by noting, as the government acknowledged, that the Ocean Vista and Royal Towers "four party" transactions both qualified as like-kind exchanges under Section 1031(a)(1). The court added that the government did not argue that Section 1031(f)(1)'s restrictions on direct exchanges between related parties applied to these indirect transactions, because in a like-kind exchange conducted through a QI Reg. 1.1031(k)-1(g)(4)(i) provides that "the qualified intermediary is not considered the agent of the taxpayer." Therefore, the QI was Teruya Brothers' exchange counterparty and the exchanges did not occur with a related person under Section 1031(f)(1).

Thus, the court found that the exchanges at issue could be denied nonrecognition treatment only if they were part of a transaction (or series of transactions) structured to avoid the purposes of Section 1031(f). To discern Section 1031(f)'s purposes, the court looked first to the language of the statute. The Ninth Circuit said that Section 1031(f)'s existence showed that Congress wanted to limit the ability of

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7 This concession—that Section 1031(f)(4), rather than Section 1031(f)(1), is to be applied to exchanges involving only QIs—is consistent with the Service's concession in the Tax Court in Teruya Brothers, as well as the National Office ruling position in Ltr. Ruls. 200810017 and 200810016. Thus, the IRS is apparently no longer following the position it took in FSA 199931002, that Section 1031(f)(1) applied, triggering gain in the later year (under examination) of the subsequent disposition, rather than Section 1031(f)(4), which would have triggered gain in the apparently closed year of the initial exchange.
related parties to claim nonrecognition treatment for Section 1031 exchanges, but as Teruya Brothers' exchanges were not expressly covered under Section 1031(f)(1), the court could not, on the statutory language alone, conclude that Congress wanted to deny these transactions nonrecognition treatment.

The court next looked to the legislative history of Section 1031(f). It noted that the House Report established that one of Congress's primary concerns in writing Section 1031(f) was that the like-kind standard was too broad and had allowed taxpayers nonrecognition treatment where they had significantly changed their investment. Congress believed that nonrecognition treatment was appropriate only for exchanges where the taxpayer can be viewed as merely continuing his investment and wanted to prevent related parties from using Section 1031(d)'s basis-shifting provisions to cash out of an investment and avoid taxable gain. After reviewing the legislative history, the Ninth Circuit concluded that the Tax Court did not err in determining that the taxpayer's transactions were structured to avoid the purposes of Section 1031(f). The court believed that transactions that allow related parties to receive nonrecognition treatment while cashing out their investment by using Section 1031's basis-shifting provisions were the type of transactions that Congress was attempting to curtail when it enacted Section 1031(f)(4).

The court rejected Teruya Brothers' contention that the economic consequences of the transactions to Times were irrelevant to its inquiry, and that Teruya Brothers' continued investment in real property was dispositive of the issue. The Ninth Circuit noted that Section 1031(f)(1)(C)(i) disallows nonrecognition treatment if the related party disposes of exchanged property within two years, regardless of whether the taxpayer does as well. Thus, the court found that examining the taxpayer and related party's economic position in the aggregate often was the only way to tell if Section 1031(f) applied and that the taxpayer and the related party should be treated as an economic unit in that inquiry.
Analyzing the facts, the appellate court found that the changing economic positions of Teruya Brothers and Times showed that the related parties used the exchanges to cash out of an investment in low-basis real property: before the exchanges, Teruya Brothers owned Ocean Vista and Royal Towers, and Times owned KI, KII, and K; after the exchanges, Teruya Brothers owned KI, KII, and K, and Times had cash from the sale of Ocean Vista and Royal Towers (along with boot from Teruya Brothers). As a result, Teruya Brothers and Times decreased their investment in real property by approximately $13.3 million, and increased their cash position by the same amount.

The court added that Teruya Brothers could have achieved the same dispositions through far simpler means, such that the transactions appeared to be structured for no other purpose than to seek to avoid Section 1031(f). Teruya Brothers could have exchanged Ocean Vista and Royal Towers directly with Times, followed by Times selling Ocean Vista and Royal Towers to the third-party purchasers. To avoid the adverse tax consequences under Section 1031(f)(1) of the direct exchanges, Teruya Brothers employed a QI, whose involvement in the transactions served no purpose other than to make simple but tax-disadvantageous transactions more complex in order to avoid Section 1031(f)(1).

Although the court concluded that the transactions were structured to avoid the purposes of Section 1031(f), its inquiry did not end there. Teruya Brothers argued, and the Tax Court held, that Section 1031(f)(2) provided an additional limitation on the scope of Section 1031(f)(4). Section 1031(f)(2) establishes several circumstances by which a related-party exchange still may qualify for nonrecognition treatment even though it technically violated Section 1031(f)(1). The broadest exception, Section 1031(f)(2)(C), allows otherwise improper exchanges to earn nonrecognition treatment if it is established that neither the exchange nor the subsequent disposition had the avoidance of federal income tax as one of its principal purposes.

The court noted that the Section 1031(f)(2) exceptions applied only to exchanges that violated Section 1031(f)(1), unlike the exchanges at issue. The Ninth Circuit agreed with the Tax Court's holding
that because Section 1031(f)(2) was subsumed within the purposes of Section 1031(f), any inquiry into whether a transaction is structured to avoid the purposes of Section 1031(f) also should take the Section 1031(f)(2) exceptions into account. The court added that Section 1031(f)(4) denies nonrecognition treatment only to transactions that violate Section 1031(f)(1)'s purposes. Thus, the court concluded that since transactions falling within Section 1031(f)(2)'s exceptions by their very nature do not violate those purposes, Section 1031(f)(2) must independently limit Section 1031(f)(4)'s scope. In other words, a transaction does not violate Section 1031(f)(4) if the taxpayer can establish to the Service's satisfaction that the transaction did not have as one of its principal purposes the avoidance of federal income tax.

The court found ample support for the Tax Court's conclusion that the transactions were structured for tax-avoidance purposes through an examination of the tax consequences of the two exchanges. A direct sale of Royal Towers would have caused Teruya Brothers to recognize approximately $11 million of gain; a direct sale of Ocean Vista would have caused Teruya Brothers to recognize approximately $1 million of gain. With the transactions structured as like-kind exchanges, however, only Times had to recognize any profit, and Times paid no tax on such profit due to its available NOLs. Clearly, the Teruya Brothers/Times economic unit achieved far more advantageous tax consequences by employing a like-kind exchange than it would have if Teruya Brothers simply sold its properties to the third-party buyers directly. Thus, the Ninth Circuit concluded that the record supported the Tax Court's determination that unwarranted avoidance of federal income tax was one of the principal purposes behind the exchanges.

The last point that the court addressed was the taxpayer's contention that it did not have an improper tax-avoidance purpose because it never had any fixed right to cash at the time of these transactions, since Teruya Brothers always had insisted that the transactions be structured as like-kind exchanges, rather than sales. The court dismissed this assertion, noting that while perhaps germane to whether the transactions were exchanges or sales under Section 1031(a), the taxpayer's undisputed intent to complete a like-kind exchange was irrelevant to whether the transactions at issue were structured to
avoid the purposes of Section 1031(f). Moreover, by focusing only on its own continued investment in like-kind property (i.e., Teruya Brothers did not receive cash), the court stated that Teruya Brothers ignored the crucial tax consequences of these exchanges to its related party, Times.

**Comparative Tax Price Analysis**

As a footnote to its penultimate point, the court commented that "[t]heoretically, the tax price to Times from reducing its net operating losses may have equaled or even exceeded the tax Teruya deferred, particularly in the Ocean Vista transaction," and cited an earlier article by your authors which discussed this analytical framework. As noted by the Ninth Circuit, however, Teruya Brothers did not argue this point on appeal, even though the Tax Court clearly raised the issue in its decision, and so the circuit court did not consider that issue further. Despite references in both decisions to basis shifting and cashing-out, the authors believe that the comparative tax price analysis may have been the analysis actually used by the Ninth Circuit and the Tax Court.

In considering whether the transaction came within Section 1031(f)(4), the Tax Court focused on the fact that "[t]he 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." As discussed above, the Ninth Circuit also focused upon how "the changing economic positions of Teruya and Times readily show that the related parties used these exchanges to cash out of an investment in low-basis real property." The plain language of these statements indicates the courts looked at the before and after aggregate property-cash positions of Teruya Brothers and Times, but nothing in either opinion suggests that either court considered whether there was any abusive basis shifting in the transactions. Thus, it is difficult to conclude that basis shifting is the definitive factor in the courts' decisions.

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Instead, the Tax Court introduced, and the Ninth Circuit followed, a comparative tax price analysis, which asks whether an exchange and a subsequent disposition increases the exchanger's and related party's aggregate cash position (and thus equally decreases the aggregate property position), and then compares the tax the exchanger attempts to defer on this cash under Section 1031 to the tax price incurred by the related party on the transaction. Under this analysis, if there is a cash-out and the related party incurs a tax price that is lower than the tax the exchanger defers, then the transaction does not qualify for Section 1031 nonrecognition. Thus, although the analysis is predicated on a cash-out, the actual outcome of the analysis depends on the tax positions of the related parties after the exchange, as compared to the tax that the related parties sought to avoid by means of their exchange structure. Because Times paid no tax for the year of the exchange, the courts appear to have concluded that its tax price was less than the tax Teruya Brothers deferred.

If tax price is the actual analysis, how might future courts decide the outcome of related-party exchanges? Is the appropriate comparative tax price analysis "gross" in application or should it factor in all tax consequences on a net present value basis? How should speculative or competing outcomes be dealt with in computing net present value?

If any tax price analysis is to be applied correctly, "tax price" must be defined. The courts' definition of tax price seems to look only at the exchanger's deferred gain for the year of the exchange and the related party's tax liability for that year, i.e., it analyzes the tax price from a "gross" perspective.

This approach excludes other nuances such as tax rate disparity and timing differences that also may create a tax price differential. NOL carryforwards and carrybacks also could affect a tax price analysis, since the offsetting of the loss carryforwards is the economic equivalent of eventually paying tax on the gain. (The reduced loss carryovers will require the taxpayer to pay tax on income sooner than would have been the case if the taxpayer had not recognized the gain.) Thus, an exchanger might argue that any loss carryforwards to its exchange year, and perhaps even any post-exchange-year loss
carrybacks to its exchange year, that are projected by the exchanger at the time of the exchange, are relevant and might nullify the existence of a tax-avoidance plan.

The tax price for both the exchanger and the related party also can be affected by each party's respective tax bracket. For example, suppose an exchanger controls a charity and thus is related to that charity under Section 267(b)(9). Suppose further that the exchanger exchanges property with the charity, which then disposes of the property within two years. Suppose also that the charity's property had a lower basis than the exchanger's. In that situation, the charity's low basis is transferred by the charity to the exchanger's former property under Section 1031(d).

In that event, in sharp contrast to the situation of Royal Towers in *Teruya Brothers*, the related-party like-kind exchange in effect creates a *larger*, rather than *smaller*, gain to the exchanger/related-party group in the year of the related party's subsequent disposition. Nevertheless, the charity could avoid inclusion of that larger-than-exchanger's gain on the subsequent disposition under Section 512(b)(5), which generally excludes from the definition of unrelated business taxable income gain on the sale of investment property. In that instance the charity's tax price would be zero. The comparative tax price analysis would seem to require the exchanger to recognize any realized gain on the exchange.

This example is an all-or-nothing situation, since the charity will never recognize gain on the disposition of its exchange property. If, instead of being a charity, however, the related party was in a lower tax bracket, then perhaps-depending on the exchanger's and related party's relative bases-the comparative tax price analysis might not require the exchanger to recognize the gain realized on the exchange.

More generally, since the effect of allowing Section 1031(a)(1) nonrecognition is merely a timing difference to the exchanger and the related party, a "tax price" concept, and particularly a tax price concept that focuses only on the year of the exchange and does not take into account the time value of money, seems to make little economic sense. The IRS in FSA 200137003 acknowledged that Sections
1031(f)(1) and (f)(4) do not prohibit, and indeed by negative inference seem to allow, basis shifting cash-outs using a related party as long as the cash-out occurs more than two years after the exchanger's exchange.

The FSA clearly views the statute as prohibiting basis shifting cash-outs only during the two-year period prescribed in Section 1031(f)(1)(C). But Section 1031(f)(1) is somewhat odd because the prohibited acts (disposition of either property received) are considered completely acceptable simply if they occur two years and a day after the exchange, rather than within two years of the exchange. The statute itself seems to have a very narrow time horizon, which rewards exchangers and their related parties who have the business plan, financial resources, and patience to wait out the proscribed time. So perhaps the courts' myopic one-year snapshot of the Teruya Brothers-Times property-cash positions is perfectly defensible, given the general two-year framework of the statute.

Tax administration concerns also may justify ignoring loss carryforward reductions and other indefinite outcomes because of the speculative nature of post-exchange-year income and the time value of the exchange-year tax savings that are eventually repaid in a post-exchange-year profitable year. Indeed, taking into account the deferred tax on the deferred gain could as a practical matter eliminate the application of Section 1031(f).

An exchanger could nevertheless legitimately argue that it is not the hypothetical tax liability that the exchanger avoided through the related-party exchange that should be viewed as the exchanger's "tax price." Instead, the comparative tax price analysis should consider the net present value of the overall tax consequences to the exchanger group, rather than the "gross" tax savings approach that the courts appear to espouse.
Ocmulgee Fields. It looked like your authors’ framework might be put to the test in another Section 1031(f) case decided in 2009, *Ocmulgee Fields, Inc.*, 132 TC No 6, Tax Ct Rep (CCH) 57777, Tax Ct Rep Dec (RIA) 132.6, 2009 WL 884535.9

As in *Teruya Brothers*, the taxpayer in this case had acquired its replacement property from a related party (a partnership) using a QI, although unlike *Teruya Brothers* the taxpayer had identified two additional replacement properties owned by unrelated parties.10 The taxpayer put forward five "monumental" factors that provided tax reasons which it contended should override the basis-shifting aspects of its exchange. These factors all allegedly affected the comparative tax price of the exchange:

1. There was an immediate tax on the related party's sale of the replacement property.

2. The exchange accelerated the tax to the taxpayer on the outstanding installment note from its prior sale of the same property to the related party.

3. The taxpayer would be entitled to less depreciation on the replacement property than its related party had been.

4. The taxpayer's tax rate was higher than the individual capital gains rate that applied to the partners of the related party.

5. The gain to the owner of 70% of the related party would have been eliminated after his death via a Section 754 election.

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9 See Lipton, "Tax Court Again Rejects Purchase From a Related Person of 1031 Replacement Property," 110 JTAX 357 (June 2009).

10 The taxpayer also tried to distinguish its transaction from that in Teruya Brothers on the grounds that there was no prearranged plan to acquire the replacement property from its related party and the acquisition of the replacement property from its related party occurred only because it was unable to acquire the other replacement properties (owned by unrelated parties) that it had identified. The court was unpersuaded by that distinction, noting that that fact had not been of much weight in the Teruya Brothers decision, and ultimately decided that there was a "prearranged plan" for the acquisition of the related-party replacement property as of the date the relinquished property was sold.
The Tax Court rejected these five factors as unconvincing, erroneous, speculative, or neutral at best, noting that although there may be situations in which a taxpayer can overcome the negative inference to be drawn from a basis shifting and cashing out, this was not one of them. To determine the taxpayer's principal purpose for the structure of the transaction, the court examined what would have been the effects of the transaction had the QI not been used. Examining all of the facts, the court found the tax savings plain and ruled against the taxpayer. Nevertheless, it specifically noted that it was not prepared to say, as a matter of law, that a finding of basis shifting precludes the absence of a principal purpose of tax avoidance.

The authors' theory remains untested, because although the Tax Court in *Ocmulgee Fields* appeared to be receptive to the idea that tax considerations could affect the outcome of a Section 1031(f) case, it rejected all of the taxpayer's proffered tax considerations. Related parties with an appetite for exchanges and controversy (and an indifference to penalties) still might want to consider this theory as part of their assessment of their odds of success.\footnote{Although the Tax Court firmly dismissed those five "monumental" factors, it did not impose an accuracy-related penalty under Section 6662(a), even though there was a substantial understatement on the taxpayer's tax return due to the exchange. Section 6664(c)(1) provides that the accuracy-related penalty is not imposed with respect to any portion of an underpayment if it is shown that there was reasonable cause for that portion and the taxpayer acted in good faith with respect to that portion. The Regulations further provide that the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances; reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. See Regs. 1.6664-4(b)(1) and (c). Here the court declined to impose the penalty because the taxpayer relied on an experienced tax return preparer and the return was filed before the issuance of the court's decision in *Teruya Brothers*. The court further acknowledged that Section 1031(f)(4) was not without interpretative difficulties, and although the IRS had issued Rev. Rul. 2002-83, 2002-2 CB 927, which presaged the result in *Teruya Brothers*, the Tax Court did not think that the Revenue Ruling left the outcome free from doubt or that the return preparer made unreasonable legal assumptions.} The Tax Court in *Ocmulgee Fields* gave the taxpayer a pass on penalties, but with that decision and the taxpayer-adverse Tax Court and appellate decisions in *Teruya Brothers* now on the books, the next court is not likely to be so kind.

**Viable Like-Kind Exchange Opportunities using Related Parties**

Although certain related-party exchanges pose a problem, many do not. Some alternatives may help taxpayers avoid the problems of related-party exchanges.
Learn to be patient

The most obvious "good" technique is a direct related-party exchange where the exchangers can wait for at least two years and a day before either or both of them sell the acquired property. The IRS in FSA 200137003 clearly believes that the statute means what it says and that the prohibition against related-party exchanges in Section 1031(f)(1) is directed only at exchanges where the parties dispose of either property within the two-year period.

Where a direct exchange is not an option, indirect exchanges using a QI have worked where both related parties have been engaged in their own exchanges. For example, in Ltr. Rul. 200616005, the Service approved the exchanger's transfer of its relinquished property to the related person as its replacement property in its own exchange but required that both the exchanger's replacement property acquired from a third party and the related party's replacement property be held for the two-year period mandated by Section 1031(f)(1).12

The converse of this transaction also has been approved by the IRS in several recent private letter rulings, which conditioned the favorable rulings on both the exchanger and its related party holding their acquired property for two years.13 In each of these rulings, the exchanger, using a QI, transferred its relinquished property to a third-party buyer and obtained its replacement property from the related party, while the related party, using the QI, obtained its replacement property from a third party.

What is interesting about both sets of these rulings is that although the IRS explicitly acknowledged that there was no "cashing out" by either of the related parties in the economic unit, it still imposed the two-year waiting period for the disposition of the acquired properties. Presumably, this is based on the fact that the related party acquired as its replacement property the taxpayer's relinquished property using the pre-tax proceeds from the sale of its relinquished property in its own like-kind

12 See also Ltr. Rul. 200440002 (similar transaction).
13 Ltr. Ruls. 200820025, 200820007, 200810017, and 200810016.
exchange or the taxpayer acquired its replacement property from a third party using the pre-tax proceeds from the sale of its relinquished property to the related party.\textsuperscript{14}

\textit{Not All Relationships Are Bad}

Another option may be simply to not be related. Section 1031(f) uses the same definitions of related persons contained in Sections 267(b) and 707(b)(1). Thus, an exchange between a person and a corporation in which that person owns only 50\% (i.e., not "more than 50\%," which is the trigger that the statute uses) of the stock is not, by definition, a related-party exchange and Section 1031(f) does not apply. Similarly, blood relatives are considered related persons but a relative-in-law is not. Thus, an exchange between a brother and his brother-in-law is not considered a related-party exchange.

The Service ruled favorably in two recent identical rulings, apparently requested by siblings. In Ltr. Ruls. 200919027 and 200920032, parents died leaving their farmland to their three children in equal shares as tenants-in-common. The three children deeded their undivided interests to grantor trusts set up for each of them. One child died and her interest, then stepped-up to a higher FMV than the undivided interests in the other two trusts, passed to a trust for the deceased's husband and two children (the "high-basis trust"). The co-trustees of the high-basis trust were the spouse and children of the deceased. This trust wanted to cash out of its investment.

The taxpayers requesting the rulings were each the owner of one of the other two trusts (the "low-basis trusts"). Thus, these taxpayers were the brothers-in-law and uncles or aunts of the trustees and beneficiaries of the high-basis trust.

The three trusts proposed to exchange their undivided one-third interest as tenants-in-common for a fee simple interest in one-third of the farmland that had been surveyed out into three equal pieces, as allowed under Rev. Rul. 73-476, 1973-2 CB 300. The high-basis trust proposed to then sell its parcel to an unrelated third party. The issue was whether this sale disqualified the exchanges of the low-basis trusts.

\textsuperscript{14} See note 20, \textit{infra}. 
under Section 1031(f)(1), since those trusts had exchanged their low-basis undivided one-third interests in that parcel to the high-basis trust, which, within two years, used its relatively higher basis to reduce the gain on the sale. The IRS, noting that the two owners of the low-basis trusts were not related to the high-basis trust or any of the high-basis trust trustees under Section 1031(f)(3), held that the exchanges by the low-basis trusts qualified under Section 1031(a).

_Sometimes Breaking Up Is The Right Thing To Do_

Ltr. Rul. 200730002 involved a more complex situation. The taxpayer and his two brothers had each inherited a one-third co-ownership interest in each of two properties, Greenacre (FMV $6x) and Blackacre (FMV $3x), on the death of their mother. One brother transferred his one-third interest in Greenacre and Blackacre to a trust that was a grantor trust, and subsequently died. Under the trust instrument, the one-third interests in Greenacre and Blackacre were to be distributed outright to the decedent's daughter, who was the niece of the taxpayer. Difficulties involved in dealing with one-third interests in Greenacre and Blackacre delayed the distribution from the trust to the niece.

At the time of the ruling, the taxpayer was the trustee of the trust and had been managing Greenacre and Blackacre. The taxpayer planned to resign as trustee, at which time his niece would become the successor trustee, thereby becoming both legal and beneficial owner of the trust's one-third interest in Greenacre and one-third interest in Blackacre and also entitled to immediate distribution of the properties. The IRS specifically noted that, as a result of the resignation, at the time of the transaction the taxpayer had no fiduciary or Section 267(b) relationship to his niece or the trust and that for purposes of the ruling the niece would be treated as the one-third owner of the properties.

As is often the case, there was a family difference of opinion on what to do with the two properties. The brother and niece wanted to sell Greenacre and Blackacre. By contrast, the taxpayer wanted to remain invested in either Greenacre or Blackacre, but also to be relieved of the burden of managing Greenacre and Blackacre for the benefit of his brother and niece. The taxpayer found a buyer
for Greenacre and the parties agreed on a swap by which taxpayer would exchange his one-third interest in Greenacre (worth $2x) for his brother's and niece's combined two-thirds interest in Blackacre (also worth $2x). After this exchange, the brother and the niece would sell Greenacre to the buyer and split the proceeds. The taxpayer would continue to own Blackacre and lease it to commercial tenants.

Since the niece's trust had been revocable in the hands of her deceased father, the trust's one-third basis in Blackacre was apparently stepped-up under Section 1014, so the niece's pre-sale-swap of one-third of Blackacre for one-sixth of Greenacre owned by the taxpayer probably resulted in a smaller gain for the niece on resale of that one-sixth of Greenacre acquired from the taxpayer than the taxpayer would have recognized had the taxpayer hypothetically sold the one-sixth of Greenacre directly to the niece's buyer. On the other hand, the ruling implies that as a factual matter the brother's basis in the brother's pre-swap one-third interest in Blackacre was smaller than the taxpayer's basis in the one-sixth of Greenacre swapped to the brother, so that the brother recognized a larger gain on resale of the one-sixth of Greenacre acquired from taxpayer than taxpayer would have recognized had taxpayer hypothetically sold the one-sixth of Greenacre directly to the brother's buyer.\(^{15}\)

The two exchanges were potentially subject to Section 1031(f)(1), as to the taxpayer and his brother and also as to the taxpayer and the trust prior to his resignation. Therefore, the IRS looked to Section 1031(f)(2)(C) to determine whether the parties could demonstrate a lack of a tax-avoidance motive and concluded that the exchange was directly covered in the legislative history. This states, in part, that "[i]t is intended that the non-tax avoidance exception generally will apply to: (i) a transaction

\(^{15}\) Ltr. Rul. 200730002 states "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." Since this seems to be intended to reflect the absence of basis shifting, the phrase "Brother's basis in the Properties is lower than Taxpayer's basis" is apparently meant to mean that the brother's basis in the property exchanged by the brother (i.e., one-third of Blackacre) is less than the taxpayer's basis in the property exchanged (i.e., one-sixth of Greenacre).
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....”16

Despite this favorable conclusion, the Service then considered whether "the transaction (or series of transactions)" had been structured to avoid the purposes of Section 1031(f). Since the brother's gain was higher than the taxpayer's would have been due to the brother's relatively lower basis, there was no tax-free cash-out due to basis shifting, thereby negating tax-avoidance intent.17 In other words, in the converse of the Teruya Brothers and Ocmulgee situations—where the taxpayer cashes out but the tax price to the related party exceeds the taxpayer's tax savings—the "tax price analysis" points to a finding of non-tax-avoidance.

With respect to the niece, the potential IRS concern may be that the resignation of the trustee, which made the taxpayer and the trust/niece unrelated, could be considered "structuring" within the meaning of Section 1031(f)(4), which seems evident from the Service's statements that had the distribution of the trust properties occurred in a timely manner the taxpayer would have had no Section 267(b) relationship with the niece and that the same would be true if the taxpayer resigned as trustee at or near the time of the exchange.

This is the first time that the IRS has ruled on a situation where the parties disaffiliated from each other prior to an exchange. The ruling effectively concluded that the determination of a relationship between the taxpayer and the trust/niece was to be made at the time of the exchange and therefore without consideration for the immediate pre-exchange resignation as trustee. It might be inferred that the same result might be reached in other contexts, such as those involving related corporations or partnerships. It is obviously speculative to conclude that a pre-exchange transfer of stock or partnership interests intended

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16 See S. Print No. 56, supra note 4.
17 Indeed, one might view Ltr. Rul. 200730002 as suggesting that the additional tax on sale of Greenacre payable by the brother relative to the taxpayer by reason of the brother's pre-exchange swap for one-sixth of Greenacre could be netted against the tax savings on sale of Greenacre by the niece by reason of the niece's pre-exchange swap for one-sixth of Greenacre in determining whether reducing the "tax price" of the related-party group was a principal purpose of the exchange.
to break the relationship by bringing two corporations or two partnerships at or below the level of 50% common control would receive equally favorable Section 1031(f) treatment. Nevertheless, the ruling suggests such outcome is possible.18

On the other hand, Ltr. Rul. 200730002 does not address the possible application of other anti-abuse concepts outside of Section 1031(f), such as conduit principles, notwithstanding that the taxpayer apparently sought a buyer for all of Greenacre, including taxpayer's own one-third interest in Greenacre, and negotiated a nonbinding letter of intent for the sale of all of Greenacre, including taxpayer's own one-third interest in Greenacre, to the unrelated cash buyer, before the swap. TAM 200126007 observes that Section 1031(f) "is patterned on" the related-party resale rules of Section 453(e).

The legislative history of Section 453(e) indicates that the enactment of that section does not preclude the IRS from arguing in appropriate cases that an intermediary, who purchases real property in an otherwise no-immediate-recognition installment sale from the taxpayer, and immediately resells that real property to a cash buyer pursuant to a prearranged plan between the taxpayer and the cash buyer, is a mere conduit unable to defer tax to the taxpayer on the intermediary's cash sales proceeds, even if the intermediary is not related to the taxpayer within the meaning of Section 453(e).19 That is, because of conduit principles, the fact that the taxpayer is not technically related within the meaning of Section 1031(f)(3) to the party with which it swaps, directly or through a QI, does not ensure that nonrecognition is available to the taxpayer.

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18 Such transfers would nominally terminate the related-person status of two corporations (pursuant to Section 267(b)) or two partnerships (pursuant to Section 707(b)).
19 S. Rep't No. 96-1000, 96th Cong., 2d Sess. (1980) ("It is to be understood that the provisions governing the use of the installment method to report sales between related parties, and the definition of such relationships, are not intended to preclude the Internal Revenue Service from asserting the proper tax treatment of transactions that are shams"). See generally Ltr. Rul. 8738001. See also_regs. 1.482-1(f)(2)(iii)(A) and -1(i)(4).
In Ltr. Ruls. 200919027 and 200920032, there was no indication that the low-basis trusts negotiated for a resale of their property to the high-basis trust's cash buyer. Ltr. Ruls. 200919027 and 200920032 conclude that because the high-basis trust was unrelated to the low-basis trusts, "consequently" the low-basis trusts' swap with the high-basis trust was not disqualified from Section 1031(a) nonrecognition by the high-basis trust's resale of the former low-basis trusts' property. In other words, Ltr. Ruls. 200919027 and 200920032 may merely indicate that where there is no evidence of pre-existing negotiations between the taxpayer and the unrelated party's cash buyer to sell the low-basis taxpayer's former real estate, or other indications of conduit-type transactions, neither conduit principles nor Section 1031(f) apply.

Although Ltr. Rul. 200730002, like Ltr. Ruls. 200919027 and 200920032, finds Section 1031(f) inapplicable where the parties are unrelated at the time of the exchange, Ltr. Rul. 200730002, unlike Ltr. Ruls. 200919027 and 20090032, omits any affirmative statement that the taxpayer "consequently" is not disqualified from Section 1031(a) nonrecognition. This omission, however, could be explained by the failure of the taxpayer in Ltr. Rul. 200730002 to request such an IRS concession, rather than any real concern by the National Office that conduit principles should be applied against that taxpayer. Rather, the Service's finding of the existence of the non-tax-avoidance purpose, based on a scenario described in the legislative history of Section 1031(f)(2)(C), may have been such that it found no need to apply another anti-abuse theory.

At the very least, Ltr. Rul. 20073002 indicates that the Service's inclination to apply the conduit theory where the taxpayers have otherwise seemingly passed the statutory tests of non-relatedness at the time of the exchange under Section 1031(f)(3) remains highly speculative, at
least where the exchange would meet the non-tax-avoidance exception of Section 1031(f)(2)(C) if the taxpayers were hypothetically still related.

Try a Change of Perspective

If exchangers cannot avoid being related or cannot wait two years, there are still a few options.

One approach is to transfer relinquished property to the related party and use the exchange proceeds to acquire property from an unrelated party. The elements common to the exchanges in *Teruya Brothers* and *Ocmulgee Fields* are, through QIs, the exchanger's acquisition of the replacement property from a related person and the exchanger's sale of the relinquished property to a third party. When the transaction is transposed, however, and the related person acquires the relinquished property from the exchanger and the exchanger then acquires the replacement property from the third party, the abuse apparently disappears and the exchange is not a related-person exchange under Section 1031(f).

The IRS has approved the use of this technique in Ltr. Ruls. 200709036, 200712013, and 200728008. Although the Service's conclusions in these three rulings may seem almost counterintuitive, these conclusions are technically correct and make sense from a tax policy perspective. Unlike the situation where the exchanger acquired its replacement property from the related person and sold its relinquished property to a third party, this transaction cannot be recast as a direct exchange followed by a sale to the third party that would be covered by Section 1031(f)(1). Because the related person is not exchanging any of its property, there is no high-basis asset whose basis is transferred to the taxpayer's low-basis asset prior to its disposition but which is retained in the "group" consisting of the taxpayer and related party and which serves as the repository for the built-in gain deferred by the taxpayer.
Starting only with cash, presumably representing after-tax proceeds\textsuperscript{20}, the related person purchaser of the relinquished property functions in the same manner that an unrelated cash purchaser of the relinquished property would. The critical point is that there is no exchange of property between the exchanger and the related person, and with no exchange of property there can be no basis shifting between the related parties, or receipt of cash from unrelated parties that is sheltered by such a basis shift. Thus, the underlying premise of Section 1031(f) is lacking.

**Conclusion**

Taxpayers who roll over their exchange proceeds into property bought by a QI from a related party achieve the pre-tax business benefit of keeping those exchange proceeds within the related-party group. But when the related party's "tax price" on the sale to the QI is zero or smaller than that of the other related party, the IRS and courts may step in to disqualify the taxpayer's deferral under Section 1031(f).

**Practice Notes**

Exchangers should scrutinize any plan involving the application of cash exchange proceeds received from an unrelated party and used by a QI to purchase high-basis replacement property from a related party, or even low-basis replacement property from a related party with NOLs or other favorable tax attributes. The IRS and courts may view such a plan as having a tax-avoidance purpose, and thus being disqualified from nonrecognition under Section 1031(f).

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\textsuperscript{20} Contrast this with the use of pre-tax proceeds to acquire the relinquished property, as in Ltr. Ruls. 200616005 and 200440002, where the related party acquired the taxpayer's relinquished property as its replacement property using the proceeds from the sale of its relinquished property in its own like-kind exchange. In these rulings, the IRS required that the properties acquired be held for two years.
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