Brooklyn Law School

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Related-Party Like-Kind Exchanges

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I. INTRODUCTION

Related-party exchanges under section 1031 raise many technical, theoretical, and policy issues. Unfortunately, this topic has not received attention commensurate with the challenges it presents. This Article fills that void to a significant extent. The Article begins with a discussion of the purpose of section 1031 and then demonstrates how related-party exchanges could frustrate that purpose if not properly governed. The Article then discusses the history of section 1031(f), the related-party exchange rules. Many students of section 1031(f) realize that it derived from section 453(e), which governs installment sales to related parties. The Article therefore discusses the development of section 453(e) and how it informs the analysis of section 1031(f).

After laying that groundwork, the Article describes section 1031(f) and analyzes IRS and court interpretations of its coverage. Following that, the Article explores an enigma within an enigma, the non-tax-avoidance exception in section 1031(f)(2)(C). Despite a 2005 Tax Court decision construing that exception, the scope of section 1031(f)(2)(C) remains unclear. The Article considers several viable interpretations of the scope of the non-tax-avoidance exception. Finally, the Article discusses procedural issues that section 1031(f) raises and presents tax planning considerations involving related-party exchanges.
II. THE TROUBLE WITH RELATED-PARTY EXCHANGES

A thorough examination of related-party exchanges should begin with a review of the purposes of section 1031. The review identifies the continued investment purpose as the primary justification for section 1031 and describes how related-party exchanges may violate that purpose. Under the continued investment purpose, an exchanger should not recognize gain or loss on a like-kind exchange because the exchanger is deemed to continue its investment in like-kind property and has not received cash or another form of non-like-kind property. The continued-investment purpose also provides a basis for testing related-party exchange rulings and court decisions to determine their validity and their effectiveness in preventing the abuse that related-party exchanges may create.

A. The Legislative Purpose of Section 1031

A significant purpose for enacting section 1031 was Congress’s belief that “if [an exchanger’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 calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.” Thus, if the exchanger is able to demonstrate that it has not cashed out, but its capital is still “tied up in a continuing investment of the same sort,” the exchanger’s exchange should satisfy the legislative purpose of section 1031.

Equity is the basic justification of section 1031’s continued investment purpose. The court in *Jordan Marsh Co. v. Commissioner* stated that, in enacting the like-kind exchange provisions, “Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a exchanger to recognize a paper gain which was still tied up in a

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1. The purpose of section 1031 has been discussed extensively by other commentators. See, e.g., *ABA Comments on Safe Harbor Build-to-Suit Exchanges Involving Leasehold Improvements*, 2004 TNT 90-85 (May 5, 2004). See, e.g., Kornhauser, *Section 1031: We Don’t Need Another Hero*, 60 S. CAL. L. REV. 397 (1987) (questioning the stated policy justifications of section 1031); Jensen, *The Uneasy Justification for Special Treatment of Like-Kind Exchanges*, 4 AM. J. TAX POL’Y 193 (1985) (discussing the purposes of section 1031). This Article briefly reviews the purpose to set the stage for the discussion of related-party exchanges.

2. The Article uses the term “exchanger” to refer to any party who is attempting to transfer property in exchange for other property. Thus, any party attempting to come with section 1031 would be an exchanger.

3. H.R. Rep. No. 73-704 at 13 (1934); TAM 200126007 (Mar. 22, 2001) (“The most frequently cited rationale for nonrecognition of gain or loss on exchange of ‘like-kind’ properties is continuity of investment. In circumstances where a taxpayer has not ‘cashed-out’ an investment, recognition of gain or loss is not appropriate.”).

continuing investment of the same sort.” 5 The court recognized that requiring gain recognition on a like-kind exchange would create inequity. Equity requires that similarly situated taxpayers be treated similarly.6 An exchanger who exchanges property for like-kind property is similar to a taxpayer who does not dispose of property—both remain invested in property, and the taxpayer who does not dispose of property does not realize income. To maintain the equitable positions of two such similarly situated taxpayers, section 1031 provides that the exchanger who acquires like-kind property does not recognize gain or loss on the exchange. This provision subjects an exchanger of like-kind property to the same tax rules that apply to someone who remains invested in property. This is the strongest policy argument for section 1031.7

One means of determining whether an exchanger’s money is still tied up in a continuing investment is to compare the exchanger’s property position before a transaction to the exchanger’s property position after the transaction (the “continued-investment test”).8 Assume Xena LLC (Xena) owns real property, Alpha Apartment, which is worth $150,000, and has a basis of $50,000. Xena transfers Alpha Apartment to an unrelated party in exchange for like-kind real property, Zeta Building, which is also worth $150,000.9

**Continuation of Xena’s Investment**

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5. 269 F.2d at 456.
7. Although Jordan Marsh cites equity as the policy justification for section 1031, some commentators have argued that the definition of like-kind property may lead to inequities. See, e.g., Kornhauser, supra note 1; McMahon, *Individual Tax Reform For Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 Wash. & Lee L. Rev. 459, 478-79 (1993). The definition of like-kind property is beyond the scope of this article, but two of the authors question the validity of such arguments.
8. See Mercantile Trust Co. v. Comm’r, 32 B.T.A. 82 (1935); Hayden v. Comm’r, 165 F.2d 588 (5th Cir. 1980); but see Carlton v. Comm’r, 395 F.2d 238 (5th Cir. 1967); Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968) (holding that the actual or constructive receipt of non-like-kind property disqualifies the transaction, even if the taxpayer’s intent and the end result demonstrate a desire to effect a section 1031 exchange).
9. Even though the transfer of Alpha Apartment and the receipt of Zeta Building do not occur simultaneously, if the transfers are part of an interdependent transaction, Xena continues an investment of the same sort of property and should not be required to recognize gain or loss on the transaction. See I.R.C. § 1031(a)(3); Starker v. United States, 602 F.2d 1241 (9th Cir. 1979); Fredericks v. Comm’r, TC Memo 1994-27 (1994) (allowing non-simultaneous exchanges); See Brauer v. Comm’r, 74 TC 1134 (1980); Biggs v. Comm’r, 69 TC 905 (1978), aff’d, 632 F.2d 1171 (5th Cir. 1980) (granting section 1031 nonrecognition to complicated indirect exchanges). These examples assume that the transactions satisfy the general section 1031 requirements.
Related Party Exchanges

Alpha Apartment $150,000  Zeta Building  $150,000

This comparison of Xena’s property position before and after the transaction reveals that Xena owned $150,000 of real property before the transaction and owned $150,000 of like-kind real property after the transaction. Therefore, Xena continued an investment in like-kind property.

Test the equity of the rule that allows Xena to not recognize gain or loss on this transaction by comparing it to Sam Co. (Sam), the owner of Wholesale Warehouse. Sam has a $50,000 basis in Wholesale Warehouse, and it is now worth $150,000. The tax law generally does not utilize a marked-to-market gain recognition rule; thus, Sam does not recognize gain simply because its property appreciates in value. Xena’s situation is similar to Sam’s—both companies own real property before and after the transaction. Therefore, they should be subject to similar taxation. Because Sam recognized no gain, Xena should recognize no gain.

The result would be different, however, if, in exchange for Alpha Apartment, Xena were to receive Century Cinema worth $100,000 and cash of $50,000. In that situation, Xena would have partially cashed out its investment, and should recognize the realized gain to the extent of the cash received.10

Partial Cash-Out of Xena’s Investment

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<tr>
<td>Alpha Apartment</td>
<td>Zeta Building</td>
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<tr>
<td>$150,000</td>
<td>$100,000</td>
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<tr>
<td>Cash</td>
<td>$50,000</td>
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In this example, Xena’s property position after the transaction is different from Xena’s property position before the transaction. Before the transaction, Xena owned only real property, but after the transaction, Xena owns both real property and cash. Xena therefore has not fully continued its investment in like-kind property. Equity does not justify nonrecognition treatment of this transaction. Comparing Xena to Sam reveals that while Sam remains invested in real property worth $150,000, Xena changed its investment from only real property to real property and cash. If Sam were to cash out of Wholesale Warehouse, it would have to recognize gain on the transaction. Therefore, the law must require Xena to recognize gain on the transaction, but only to the extent that Xena has cashed out of its investment in real property.11

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10. I.R.C. § 1031(b) and (c) (providing that realized gain must be recognized to the extent of boot received, but loss is disallowed).
11. Section 1031 treats Xena differently than tax law would generally treat Sam on a partial cash out. Sam would recognize gain equal to the excess of the amount realized over the adjusted basis of the portion of the transferred property under section 1001(a). Thus, Sam would recover some of its
Comparing an exchanger’s property position before and after a transaction determines whether the exchanger continues an investment in like-kind property as part of an exchange, and should be used in analyzing the extent to which a related-party exchange satisfies this purpose of section 1031. A partial cash out should trigger gain recognition to the exchanger because it represents a discontinuance of an investment in like-kind property. As shown below, however, unlike an exchange with an unrelated party, a related-party exchange provides an opportunity to disguise a cash-out even though the exchange between the related parties may satisfy the technical requirements of section 1031. Thus, the continued-investment test must consider both the exchanger’s position and the related party’s position.

B. Illusory Continued Investment

Before the enactment of section 1031(f)(1), exchangers could disguise cash-out transactions by exchanging property with a related party and causing the related party to dispose of high-basis exchange property. If one looks solely at the party attempting to disguise the cash-out, the transaction would appear to be a continuation of an investment in like-kind property. The exchange would appear to qualify for nonrecognition, if it otherwise satisfies the section 1031 requirements. Examining the aggregate property position of both the exchanger and the related party before and after the exchange, however, reveals the potential abuse. The reason for aggregating the property positions of the exchanger and the related party would be that the two parties could be considered to function as an economic unit and might be willing to structure their exchange transaction from that perspective.

Assume Xena owns real property, Alpha Apartment, which is worth $150,000, and that Omega Industries Corp. (Omega), a party related to Xena, owns Double Duplex, which is also worth $150,000 and in which it has a basis of $150,000. Xena transfers Alpha Apartment to Omega in exchange for Double Duplex. After the exchange, neither Xena nor Omega has cashed out of its investment. Their aggregate position before and after the exchange remains the same.

**Continuation of Xena’s and Omega’s Aggregate Investment**

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<td><strong>Xena</strong></td>
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<tr>
<td>Alpha Apartment $150,000</td>
<td>Double Duplex $150,000</td>
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<td><strong>Omega</strong></td>
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basis on the partial cash out. Xena would recognize gain equal to the amount of boot received to the extent of realized gain. See I.R.C. § 1031(b). If the amount of boot Xena receives is less than the amount of gain it realizes, it will not recover any basis on the exchange.
Double Duplex $150,000 Alpha Apartment $150,000

Aggregate Position
Real Property $300,000 $300,000
Cash $0 $0

Comparing the property positions of both Xena and Omega before and after the exchange reveals that they each continued their investment in like-kind real property after the transaction, so their aggregate property position did not change. Because they both remained invested in like-kind real property, neither party should have to recognize gain on the exchange.

Assume now that immediately after the exchange with Xena, Omega transfers Alpha Apartment to an unrelated party in exchange for Zeta Building (like-kind property) worth $150,000. Combining both exchanges, their positions would be as follows, after the combined transactions.

**Continuation of Xena’s and Omega’s Aggregate Investment: (Omega’s Subsequent Exchange)**

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<td>Aggregate Position</td>
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<tr>
<td>Real Property $300,000</td>
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<tr>
<td>$300,000</td>
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<td>Cash $0</td>
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After the exchanges, both Xena and Omega remain invested in like-kind real property. Therefore, neither party should have to recognize gain on this transaction.

Assume that after the exchange with Xena, Omega then sells Alpha Apartment to an unrelated party for $150,000 cash. Viewing the exchange and subsequent sale together, the positions will be as followed after the combined transactions.

**Partial Cash-Out of Xena and Omega’s Aggregate Investment**

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<tr>
<td>Aggregate Position</td>
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Comparing the before-and-after aggregate property positions reveals that in the aggregate the property position of Xena and Omega went from $300,000 to $150,000, and the cash position went from $0 to $150,000. Xena’s property position, however, remained constant at $150,000. Focusing solely on Xena’s property position in this case may not be appropriate. If Xena worked in tandem with Omega to achieve tax benefits that they could only achieve through joint planning and execution, then arguably the two entities should be treated as a single taxpayer for purposes of applying section 1031. Because the parties acted in tandem and the aggregate tax position changed as a result of this transaction, equity no longer supports nonrecognition treatment. They are not in a situation that is similar to a party that remained invested in property and should not be taxed the same. Therefore, by considering the aggregate property position of Xena and Omega, the law should tax Xena’s gain.

This example demonstrates that the aggregate investment position of the two parties changed only as a result of the combined exchange and subsequent disposition for cash. If Xena and Omega acted in tandem, a focus only on Xena shows a continuation of Xena’s investment in like-kind real property. Continued investment is illusory, however, if Xena and Omega acted together. In the aggregate, the two parties did not continue an investment in like-kind properties. Thus, the analysis must consider the aggregate property position of related parties that act in tandem.

The continued investment test should consider related parties in the aggregate only if they act in tandem to exchange property and cash-out. Related-party exchanges can be quite complex, however, and the complexity makes distinguishing between illusory continued investments and bona fide continued investments difficult.

C. Issues Raised by Related-Party Exchanges

A simple comparison of the aggregate investment positions of related parties could fail to uphold properly the continued investment standard. First, merely examining the aggregate property position of the two related parties before and after the exchange on a quantitative basis alone would allow Omega to hold Alpha Apartments for a period of time after the exchange sufficient for the exchange to become old and cold, before subsequently selling it for cash. Thus, the continued-investment test must take into consideration non-proximate subsequent dispositions. In

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12. Because Xena and Omega are part of a single economic unit, equity would compare the Xena-Omega economic unit to another taxpayer. Any other taxpayer who cases out of an investment would generally have taxable gain. Therefore, the Xena-Omega economic unit should have taxable gain, under principles of equity.
other words, the comparison must also include a qualitative or time element.

Second, if the exchange and subsequent disposition are not part of the same transaction, the unrelated subsequent disposition should not be deemed to be a liquidation of an investment. Furthermore, if Omega acted on its own, the subsequent disposition should not be deemed a liquidation of Xena’s investment. The continued-investment test cannot, by itself, distinguish between unrelated subsequent dispositions and interrelated subsequent dispositions. If Omega acts on its own, equity would be violated if it compared Omega and Xena as an economic unit to another single taxpayer.

Third, the continued-investment test does not adequately test for abuse. An important aspect of section 1031 is its gain deferral mechanism. Section 1031(d) defers gain by requiring an exchanger to take a basis in replacement property equal to the basis the party had in the relinquished property.\(^{13}\) This rule creates opportunities for abuse with related-party exchanges. For example, if Xena had an adjusted tax basis in Alpha Apartment of $50,000 and Omega had an adjusted tax basis in Double Duplex of $150,000, Xena and Omega could work in tandem to shift Omega’s high adjusted tax basis to Alpha Apartment through an exchange. Omega could then sell Alpha Apartment for no gain. If Xena had merely sold Alpha Apartment for $150,000, it would have recognized $100,000 of gain.\(^{14}\) If the exchange and subsequent sale were part of a planned transaction, the parties, working together, could accomplish tax-free what they could not accomplish without section 1031, i.e., they could sell Alpha Apartment for cash tax-free. The continued-investment test would expose the discontinued investment and disallow section 1031 nonrecognition for Xena on the exchange.

The more troubling question is whether the continued-investment test reaches the correct result if the parties do not liquidate an investment tax-free. For example, if Omega’s basis in Double Duplex was also $50,000, Omega’s disposition following the exchange would result in taxable gain. Omega’s recognition of taxable gain does not present the same potential for abuse that would result if Omega had had a high basis in Double Duplex. This lack of potential abuse indicates that the tax-free cash-out and taxable cash-out should not be treated the same in determining

\[^{13}\text{I.R.C. § 1031(d) (providing that the exchanged basis will be adjusted for gain or loss recognized and for boot received); I.R.C. § 7701(a)(44) ("The term 'exchanged basis property' means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.").}\]

\[^{14}\text{I.R.C. § 1001(a) (providing that gain realized is the amount realized on the disposition of property over the adjusted tax basis of the property disposed of); I.R.C. § 1001(c) (providing that gain realized must be recognized unless another provision of the Code specifically allows non-recognition).}\]
whether the overall transaction is abusive. The continued-investment test, by itself, does not reveal this distinction.

Continuation of investment is the primary purpose for section 1031 nonrecognition. The continued-investment test provides a platform for testing the related-party exchange rules that were enacted to prevent related party abuses. Nonetheless, it is imperfect because it does not recognize when related parties do not act in tandem or when a related party recognizes gain on a subsequent disposition of exchange property. The statutory framework governing related-party exchanges appears to adopt the continued-investment test and uses a tax-avoidance test to account for weaknesses in the continued-investment test.

III. SECTIONS 1031(F)(1) AND 1031(F)(4)

In 1989, Congress enacted section 1031(f) to preserve the continued investment purpose of section 1031 and prevent related parties from using section 1031 to liquidate investments tax free. In enacting section 1031(f)(1), Congress was concerned that related parties were exchanging properties to shift basis under the section 1031(d) substituted basis rules “in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale.” In such situations, Congress believed that a disposition of an exchange property shortly following a related-party exchange allowed an exchanger to in effect use the high basis of other property in the related party group to avoid recognition of a cash-out of the exchanger’s investment. To prevent related parties from structuring transactions or series of transactions to avoid the rules of section 1031(f)(1), Congress also enacted section 1031(f)(4). The foundation of these sections appears to be the conduit theory.

A. The Section 453(e) Conduit Theory

Section 1031(f) "is patterned on" section 453(e). Section 453(e)(1) generally accelerates the gain reportable by the original seller of property under the installment method, if a related party transferee

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15. As discussed below, the presence of taxable gain on the subsequent disposition may be an indication that the exchange and subsequent disposition were not part of an integrated exchange.
18. See supra note 17.
subsequently disposes of the property within two years after the original sale.

If an exchanger sells property to a related party in exchange for the related party’s promise to pay for the property over time, the related party takes a basis in the purchased property equal to the amount promised. If the related party promises to pay the fair market value for the property, the related party’s basis in the property will equal its fair market value. Thus, the related party, unlike the taxpayer, can sell the property without tax on the property's pre-acquisition appreciation. If section 453(e) applied to the related party sale, the taxpayer would recognize gain upon receipt of installment payments. Section 453(e) prevents a taxpayer from using the installment sale rules to defer gain recognition where the related party resells the property within two years after the original sale.

Under section 453(e)(1), if the related party purchaser resells all or a part of the property within two years after acquiring it from the taxpayer, the taxpayer is required to recognize all or a portion of the deferred gain at the time of that resale. Under section 453(e)(7), however, gain to the taxpayer is not accelerated under section 453(e)(1) by reason of the related party's resale within two years if the Secretary is satisfied that neither the sale to the related party nor the related party's resale within the two-year period had as one of its principal purposes the avoidance of federal income tax. Thus, related party resales outside the two-year period generally do not trigger acceleration to the taxpayer, whereas resales within the two-year period, if not rebutted by the non-tax avoidance exception, generally do.

The rationale for the two-year period is not clear, but cases and rulings preceding section 453(e) provide some clues. The IRS attacked related-party installment sales using a conduit theory. Under the conduit theory, the related party is treated as a conduit or agent of the taxpayer. The conduit theory would apply to situations where the taxpayer intended to sell property to a third party but sold it to a related party immediately before the sale for the sole purpose of deferring gain under the installment sale rules. In such a situation, the related party would be a conduit for the taxpayer. In later cases, the IRS argued that, even if the conduit principle was inapplicable, the related party's sale should be imputed to the taxpayer.
under the assignment-of-income doctrine, or that the taxpayer was in constructive receipt of or had economic benefit from the related party's cash sale proceeds.

After reviewing various grounds of IRS attack and their limited success in the courts, the Senate Report on section 453(e) merely states that the provision was enacted to prevent "unwarranted tax avoidance by allowing the realization of appreciation within a related group without the current payment of income tax." The Senate Report gives no explanation for the two-year rebuttable presumption. Whatever the theory behind Congress' action, if related parties form an economic unit, the rules subject dealings within that unit to greater scrutiny than dealings between unrelated parties.

A conclusive presumption of conduit on all sales within two years, however, makes section 453(e) too broad. If the installment sale and subsequent disposition were not part of a single integrated plan, the conduit theory should not apply. In such a situation, the taxpayer should be allowed to report gain from the sale of the property to the related party under the installment method. Thus, it may be that section 453(e)(7) was intended to permit the taxpayer to show that the related party's resale was not pursuant to a conduit-type arrangement.

Congress probably did not base section 453(e) on the assignment-of-income doctrine. By the time Congress enacted section 453(e), courts and the IRS had already rejected the assignment-of-income theory, outside of its application to conduit type arrangements. The Fifth Circuit reasoned that the assignment-of-income doctrine was inapplicable because the taxpayer was not contending that it should not recognize gain on sale to the related party, but rather that it should defer reporting the gain as allowed under the installment method. Thus, the assignment-of-income doctrine appears to be an unlikely justification for the two-year period.

If constructive receipt is the justification for the two-year period, then the taxpayer would be deemed to own or control the money or property received by the related party. The expiration of two years

25. See Rushing v. Comm'r, 441 F.2d 593 (5th Cir. 1971), aff'd 52 T.C. 888 (1969) (holding that the sale to an irrevocable trust qualifies for installment sale treatment).
28. See id. at 13 ("The seller would achieve deferral of recognition of gain until the related buyer actually pays the installments to the seller, even if cash proceeds from the property are received within the related party group from a subsequent resale by the installment buyer shortly after making the initial purchase." (emphasis added)); Ruppert, supra note 22 at 48 ("In effect, the seller and related party, as an economic unit, obtain the benefit of installment reporting while having access to the full sales proceeds." (emphasis added)).
29. See Rushing 441 F.2d at 597; GCM 36862 (Sep. 27, 1976).
30. See Rushing, 441 F.2d at 597 (noting also that the parties did not attempt to change the character of the gain involved or shift gain to a taxpayer with a lower tax rate).
31. See Griffiths v. Comm'r, 308 U.S. 355 (1939) (disregarding a transfer to a wholly-owned corporation).
should not impact the economic or legal rights the taxpayer has to property held by the related party. Thus, constructive receipt probably is not the justification for the two-year period.

Finally, one could speculate whether the two-year period addresses the benefit of gain deferral (the benefit-of-deferral theory). Deferring gain defers tax, and if a taxpayer can defer tax long enough, time value of money principles mitigate the impact of the tax. Under the benefit-of-deferral theory, the two-year period would consider gain deferral to be of value (or of the most value) only during the two years following the installment sale, and any gain deferral beyond two years after the installment sale would be of no (or insignificant) value. If that were the case, there would be no reason to expedite gain recognition after two years. Two years appears to be too short a time period for the time value of money to adequately diminish the economic benefit of the gain deferral. Furthermore, from a revenue-raising perspective, Congress presumably would not forgo revenues simply because a taxpayer and related party were able to wait two years to dispose of the taxpayer's formerly low-basis property. Indeed, section 453A(a)(1) imposes an interest charge on the deferred tax on certain installment sales, including an installment sale to a related party that meets the exclusion given by section 453(e) for resales by a related party beyond the two-year period. Thus, the benefit-of-deferral theory does not appear to be the purpose for enacting the two-year period.

Having eliminated the assignment-of-income doctrine, the constructive-receipt theory, and the benefit-of-deferral theory as possible justifications for the section 453(e) two-year period, only the conduit theory explains section 453(e). Because section 1031(f) is modeled after section 453(e), the conduit theory analysis should be imputed to section 1031(f) as well.

The conduit theory would generally support the continued investment purpose of section 1031 by treating the exchanger and related party as a single unit and comparing the aggregate investment of the two parties before and after the exchange. If the aggregate property position of the parties decreases as part of a related-party exchange and subsequent disposition, the transaction would not be viewed as a continuation of all the parties’ investment. Any disposition of property within two years following the exchange would be evidence that the exchange and subsequent disposition were interrelated or that the related party was merely a conduit for the exchanger’s disposition of property. This of course raises some of the same concerns that the continued-investment test raises.

In the legislative history, Congress acknowledged that section 453(e) overturns some court decisions, but that the section was necessary to
stop tax avoidance transactions.\(^\text{32}\) Congress originally established the
scope of section 453(e) in section 453(f)(1), by defining related party with
reference to persons from whom stock would be attributed under section
318. The Tax Reform Act of 1986 added section 453(f)(2), which also
incorporates related persons under section 267(b).\(^\text{33}\) Apparently Congress
believed that the relationships created a “related party group” that generally
justify taxing the taxpayer when the related party resells the property.\(^\text{34}\)

The definition of related party was a rather blunt instrument, at
once both under-inclusive and overbroad. One might argue that exchangers
have a potential way out of the overbroad nature of the attribution rules
under the non-tax avoidance exception in section 453(e)(7). The Senate
Finance Committee Report on section 453(e)(7) suggests, however, that the
non-tax avoidance exception should only apply in "exceptional
circumstances," and none of the examples in that Report suggests that
allegedly erroneous attribution could be the basis of such an exception.\(^\text{35}\)

Conversely, Congress explicitly pointed out that the related party
rules can be too narrow. For example, the definition excludes parties that
have a common economic motive to act as conduits despite the absence of
a specified relationship. Congress thus indicated that section 453(e) is only
one tool at the IRS’s disposal: the section 453(f) "definition of such
relationships [is] not intended to preclude the Internal Revenue Service
from asserting the proper tax treatment of transactions that are shams."\(^\text{36}\)

Because section 1031(f) is modeled on section 453(e), presumably
the same principles will apply. That is, as discussed in Section III.F.
below, in connection with the corresponding provision in section
1031(f)(3), related parties not acting in tandem and having adverse
economic motives should not be subject to section 1031(f) notwithstanding

\(^{32}\) S. Rep. No. 96-1000, supra note 27 at 13 ("In the leading case, Rushing v. Commissioner,
the test was held to [be] that, in order to receive the installment [sale deferral] benefits, the ‘seller may
not directly or indirectly have control over the proceeds or possess the economic benefits therefrom.’ . . . 
The Court upheld installment sale treatment for the stock sold to the trustee under the ‘control or
enjoyment’ test because the trustee was independent of the taxpayer and owed a fiduciary duty to the
children. . . . [T]he committee believes that the application of the judicial decisions . . . to intra-family
transfers of appreciated property has led to unwarranted tax avoidance by allowing the appreciation
within a related group without the payment of income tax . . . ." (footnotes omitted)).

\(^{33}\) P.L. 99-514, §624(a)(3). A question can be raised as to whether the IRS can apply the
constructive attribution rules of section 267(c) in applying section 267(b) for purposes of sections
453(f)(2) and 1031(f)(3). In Ltr. Ruls. 200541037 (Oct. 14, 2005) and 199926045 (July 6, 1999), the
IRS applied the constructive ownership rules of section 267(c)(2) in interpreting section 267(b) to find
that a section 1031(f)(3) relationship existed. Further, other Code provisions that refer to section 267(b)
only and not to section 267(c) have been interpreted by the Regulations and judicially to incorporate
section 267(c). See Treas. Reg. 1.163(j)-2(g)(1) (stating that section 267(c) attribution rules apply in
section 163(j)(4)(A), which refers to section 267(b) but not section 267(c); Persson v. Comm’r, TC
Memo 1989-567 (applying section 267(c)(2) attribution rules to section 465(b)(3)(C)(i), which refers to
section 267(b) but not section 267(c)).

\(^{34}\) See supra note 28.

\(^{35}\) S. Report 96-1000, supra note 27 at 16.

\(^{36}\) Id. at 17.
their coverage by section 267(b). Conversely, section 1031(f)(1) could disqualify the like-kind exchange even if the transferor and transferee do not come within the section 1031(f)(3) definition of related party.37

1. The bête noire of section 1031(f)(1): basis shifting and cashing out

Some of the concerns the conduit theory raise are addressed by examining whether a related-party exchange shifts basis and the related party then cashes out tax free. Indeed, Congress indicated in its legislative history that basis shifting and cashing out were abuses section 1031(f) was designed to prevent. The Senate Finance Committee Report on section 1031(f) states:

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.38

Commentators have generally agree that basis shifting for the purpose of cashing out is the evil at which sections 1031(f)(1) and (f)(4) are aimed. For example, one commentator has suggested that auto lessors’ trade-ins of low-basis leased cars for high cost new cars from related party manufacturers should qualify for nonrecognition under section 1031(f),

37. See Cohen and Morris, Tax Issues From “Father Knows Best” to “Heather Has Two Mommies,” 84 TAX NOTES 1309 (Aug. 30, 1999) (recognizing that under the Federal Defense of Marriage Act, same sex couples married under state law can escape related party characterization coverage under sections 453(f)(1), and 1031(f)(3); nevertheless, absent a non-tax business purpose for the exchange and resale, the Service can recharacterize certain transactions). Cf. Treas. Reg. §1.482-1(i)(4) (applying a broad definition of common control for purposes of applying Treas. Reg. §1.482-1(d)(2)(iii)). That latter regulation permits section 482 to override section 1031 non-recognition among commonly controlled organizations where necessary to clearly reflect income. See CCA 200408030 (non-recognition exchange of appreciated property by a parent to a subsidiary having net operating losses under section 351, which subsidiary then resells the property; subsidiary's gain on the resale properly allocated back to the parent under Treas. Reg. §1.482-1(f)(2)(iii)). Neither Teruya nor TAM 200126007 discussed Treas. Reg. § 1.482-1(f)(2)(iii), leaving uncertain its possible application to like-kind exchanges with a controlled organization in connection with the controlled organization's resale of the exchanged property to an unrelated party.

notwithstanding the sale of the trade-ins by the manufacturer’s affiliates shortly thereafter.39 That commentator has noted:

In enacting section 1031(f), Congress was targeting a very specific form of tax avoidance: impermissible basis shifting. Impermissible basis shifting occurs when related persons exchange high basis property for low-basis property in anticipation of the sale of the formerly low-basis property. The hallmarks of impermissible basis shifting are: (1) a related person that did not intend to dispose of the formerly high-basis asset; and (2) a lack of business purpose for the exchange, other than to reduce the taxes owed by the group.40

It may be observed that the two aspects are actually signs of tax-motivated intent. Basis shifting is an important aspect of related-party exchange theory because it tempers the otherwise unworkable before-and-after comparison. As stated above, if the focus is trained solely on whether the related parties’ aggregate property investment position changes, exchanges that do not shift high basis to low-basis property would be treated the same as exchanges that do. By also examining basis shifting, those transactions that shift high basis to low-basis property would be subject to section 1031(f). The focus on basis shifting requires an examination of whether the related parties’ aggregate property investment position changes as a result of an exchange followed by a subsequent disposition of one of the properties. If the aggregate property investment position changes, the analysis would then examine whether there was also basis shifting. If so, section 1031(f)(1) would appear ordinarily to apply.

2. Beyond the two-year safe harbor

The IRS has privately ruled that if there is no second disposition within two years following the exchange, section 1031(f)(1) does not apply to a related-party exchange.41 The statutory two-year period is extended, however, if certain agreements that substantially diminish the related party’s risk of holding the property are in play during the two-year period.42 For example, if the related party holds a put option with respect to the property, the two-year period is suspended during the period the related

40. Id.
41. FSA 200137003 (May 10, 2001).
42. I.R.C. § 1031(g)(1) and (2).
party holds the put option.\footnote{I.R.C. § 1031(g)(2)(A). Also, another party’s holding of a call option in the property or a short sale transaction will suspend the running of the two-year period. I.R.C. § 1031(g)(2)(B) and (C). Granting a deep-in-the-money call and making a short sale transaction are similar to actual resales within the two-year period and are evidence of a conduit relationship.} This rule is necessary to support the conduit theory. The holding of a put option by the related party following the exchange indicates that the related party was unwilling to assume the normal commercial risk in acquiring property—the assumption of a decline in value of that property. A put option thus may be an indication that the related party agreed to acquire the property for the sole purpose of facilitating the exchanger’s transfer. The existence of a put option therefore indicates that the subsequent disposition may well be part of an integrated transaction that included the exchange between the exchanger and related party.

B. Indirect Related-Party Exchanges

The before-and-after comparison disregards the form of transaction and focuses only on the result of the transaction. The case law and the Treasury Regulations concerning deferred like-kind exchanges through intermediaries focus on the form of transactions in determining the applicability of section 1031. Merely enacting section 1031(f)(1), which appears to apply only to direct exchanges between an exchanger and related parties, presented potential problems of application in a form-driven area of the Code, where direct exchanges are the exception rather than the rule. To address this concern, Congress enacted section 1031(f)(4), which provides that exchangers cannot structure an exchange which is part of a transaction (or series of transactions) to avoid the purposes of section 1031(f). Congress provided an example of the series of transactions it perceived as abusive; the IRS has ruled under section 1031(f)(4) several times; and a Tax Court case has interpreted the applicability of section 1031(f)(4).\footnote{Teruya Brothers, Ltd. v. Comm’r, 124 TC 45 (2005). This case is on appeal to the Court of Appeals for the Ninth Circuit.} Each of these various interpretations deals with differing facts, requiring some extrapolation in certain situations, to fully understand the impact of the legal authority. Considering how each interpretation addresses the continued-investment purpose helps clarify the applicability and scope of section 1031(f)(4).

1. The section 1031(f)(4) legislative history

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)].” The House Report explaining the rule provides an example that demonstrates an application of
section 1031(f)(4) to a situation where the exchanger and related party do not directly exchange property. In that example, an exchanger and related party plan a transaction to circumvent section 1031(f)(1), pursuant to which the related party transfers property to an unrelated party. Pursuant to the prearranged plan and within two years after buying the property from the related party, the unrelated-party exchanges that property with the exchanger. Just as would have been the situation if the exchanger had directly exchanged its property with the related party who then transferred it to the unrelated party, at the end of the transaction, the related party holds the consideration from the unrelated party, the unrelated party owns the exchanger's property, and the exchanger owns the related party's property acquired in an exchange. Consequently, the House Report concludes that under section 1031(f)(4) the exchanger is not allowed section 1031(a)(1) nonrecognition.45

The House Report example does not state whether the related party's property was high-basis property, nor whether the transfer to the unrelated party was for cash rather than like-kind property, nor whether the exchanger would have been subject to current tax liability upon a sale directly to the unrelated party. Presumably, some of these factors were present. If so, the transaction in that example was the same that would have occurred had the exchanger exchanged low basis property with the related party, and the related party had sold the exchanger’s former property for cash. Thus, section 1031(f)(4) prevents exchangers from circumventing the formalistic limitation of section 1031(f)(1).

The legislative history’s lack of a numerical example does not appear to indicate that Congress intended section 1031(f)(4) to adopt a simple before-and-after comparison. Instead, it demonstrates that section 1031(f)(4) prevents circumvention of the literal application of section 1031(f)(1) to direct exchanges. As stated above, section 1031(f)(1) takes into account the shift of high basis to low basis property followed by a tax-free cash-out. Thus, the transaction in the section 1031(f)(4) legislative history most likely to the prohibited basis shifting and cashing out. With this understanding, the legislative history must refer to a related party that sold high-basis property to an unrelated party for cash, recognizing little or no taxable gain on the receipt of the cash. The exchanger must have then transferred low-basis property to the unrelated party in exchange for the related party’s high basis property. Because section 1031(f)(4) brings indirect related-party exchanges within the rules of section 1031(f)(1), the indirect exchanges must have the economic equivalent of basis shifting and cashing out for section 1031(f)(4) to deny section 1031(a)(1)

45. The text above reverses the role of taxpayer and related party, to clarify the point apparently intended to be made by that example. See H.R. Rep. 101-247, supra note 17. The Tax Court in Tenny Brothers appeared to question the clarity of this example and the scope of section 1031(f)(4).
nonrecognition. Indeed, the IRS recognized this application in several of its rulings addressing indirect exchanges through a qualified intermediary.

2. IRS section 1031(f)(4) rulings

Even though the plain language of section 1031(f)(4) and the legislative history of that provision do not expressly refer to a exchanges through a qualified intermediary ("QI"), several IRS rulings present facts that demonstrate the potential for related parties to structure exchanges to avoid section 1031(f)(1). Many commentators have agreed that transactions facilitated by QIs are potentially abusive. In each of the IRS rulings, the exchanger transferred relinquished property through a QI to an unrelated party and acquired replacement property from a related party through the QI. In each case, the IRS ruled that the transaction came within section 1031(f)(4) and disallowed section 1031(a)(1) nonrecognition. The Tax Court in Teruya Brothers implicitly agreed with the IRS’s conclusions.

TAM 9748006 is the first ruling squarely applying section 1031(f) to an exchange facilitated by a QI. In TAM 9748006, the exchanger, using a QI, sold low-basis relinquished property to an unrelated party and acquired high-basis replacement property from his mother in a simultaneous exchange. The taxpayer argued that the transaction was initially structured as an exchange with unrelated parties but he was unable to acquire the real property that he wanted in time for the exchange to qualify under section 1031. This argument appears to be inapposite since the exchange was a
this series of transactions is identical to what would have occurred in a direct exchange of [properties] between Taxpayer and Related Party, followed by a sale of [the relinquished property to the unrelated party].” It further advised that “a qualified intermediary is not entitled to better treatment than the related party referred to in the House Report. Thus, the mere interposition of a qualified intermediary will not save a transaction otherwise flawed under [section] 1031(f)(1).” The IRS concluded that “[i]t is apparent that Taxpayer and Related Party utilized a QI for the sole purpose of avoiding the related party rules of [section] 1031(f).”

Although the form of this transaction differed from the form of the transaction described in the House Report, like the House Report example, it demonstrates a structure that can be used to circumvent the literal language of section 1031(f)(1). The IRS recognized that the interposition of the QI changed the form of the transaction, but the effect of the transaction was the same that would have occurred had the exchanger and his mother exchanged property with the mother later selling the son’s property tax free for cash. Thus, although the form differed from the example in the House Report, the IRS accorded it the same treatment and the end result in the TAM is the same as the example in the House Report.

The economic-result test the IRS used in TAM 9748006 is a modified version of the before-and-after comparison. The IRS examined whether the exchanger and related party had liquidated part of their pre-exchange aggregate investment property position as a result of the exchange. Having determined that they had reduced their investment property position and increased their cash position, the IRS then asked whether there was any inappropriate basis shifting. Because the exchanger’s low-basis property went to an unrelated third party, the related party received cash for high-basis property, and the exchanger ended up with the related party’s high-basis property, the exchange did not qualify for section 1031(a)(1) nonrecognition. This is the correct result.

The economic-result test used by the IRS in TAM 9748006 is also a version of the economic substance test used earlier by the Tax Court in Fredericks, a pre-section 1031(f) related-party exchange case. In that case, the exchanger transferred property to a related party. The related party sold the property, and used the proceeds to acquire land and construct a building on the land, which it then exchanged with the exchanger. Noting that neither the property nor cash positions of the exchanger and related

51. See supra note 9.
party changed between before and after the transaction, the Tax Court held that the transaction qualified for section 1031(a)(1) nonrecognition.52

The result in *Fredericks* is consistent with the continuity-of-investment purpose of section 1031. The decision can be justified based on the aggregate property-cash position of the exchanger and related party before and after the exchange. Because the aggregate property-cash position, and indeed the individual property-cash positions, did not change as a result of the exchange, the transaction deserved to qualify for section 1031 nonrecognition. Since the transaction passed the before-and-after comparison, the court did not need to look for abusive basis shifting. The only challenge the court faced was determining whether the disposition, construction, and exchange were part of an integrated plan. Being satisfied that they were, the Tax Court correctly held that the transaction qualified for section 1031 nonrecognition.

The economic substance test is also consistent with the view of some commentators that section 1031(f)(1) (and section 1031(f)(4)) should not apply where the related party acquires its high basis property (e.g., land bought from an unrelated party and a building built thereon in a build-to-suit transaction for the exchanger) in anticipation of a direct (or indirect through an QI) exchange with the exchanger. In that event, the related party’s sale of the formerly low basis property of the exchanger merely reimburses the related party for its out-of-pocket costs, and does not represent a cash-out of high basis property owned before the related-party exchange.53 The transaction does not affect the before-and-after-transaction economic positions of either the exchanger or related party.

3. *Teruya Brothers, Ltd. v. Commissioner*: The sole judicial interpretation

The stakes were high in *Teruya Brothers*,54 the first judicial decision interpreting section 1031(f).55 The exchanger in this case, Teruya

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52. The Tax Court in specifically pointed out that the transaction occurred before the effective date of section 1031(f), thereby conceding that section 1031(f) might disqualify transactions occurring after its enactment.


54. See supra note 44.

55. The facts in TAM 200126007 (Mar. 22, 2001) appear to be identical to the *Teruya Brothers* facts and holding and this TAM was apparently issued in the course of the Teruya examination. In the TAM, the IRS rejected the five arguments espoused by the taxpayer and held that the transactions did not qualify for nonrecognition treatment because of section 1031(f)(4). First, the IRS concluded that section 1031(f)(4) applies even though the transaction was not a direct exchange with a related party followed by a disposition. Second, the IRS confirmed that section 1031(f)(4) applies to multi-party exchanges that do not involve a direct exchange between the taxpayer and the related party. Third, the IRS concluded that the transaction facilitated avoidance of the purposes of section 1031(f), i.e., “basis shifting (or identical consequences) between related parties; tax-free or tax-deferred cashing out of an
Alton, Borden & Lederman

Brothers, Ltd. ("Teruya") owned two properties, "Ocean Vista" and "Royal Towers." Teruya entered into contracts to sell both these relinquished properties to parties unrelated to Teruya, contingent upon Teruya finding suitable replacement property that Teruya could acquire as part of a section 1031 exchange. Instead of looking to acquire the replacement property from unrelated parties, Teruya decided to acquire all of its replacement properties from Times Super Market, Ltd. ("Times"). Times was a C corporation, 62.5% of whose stock was owned by Teruya. Times therefore was related to Teruya under section 1031(f)(3), which adopts the definitions of relatedness in section 267(b) and section 707(b)(1). Times had a large net operating loss available for use during the taxable year of the exchange. Times and Teruya agreed on the values of the replacement properties Teruya was to acquire from Times.

Teruya acquired Kupuohi II ("KII") from Times in exchange for Ocean Vista and $1.4 million cash. Immediately before the exchange, Ocean Vista had a fair market value of $1.4 million, a tax basis to Teruya of $0.1 million, and thus an inherent gain to Teruya of $1.3 million. KII had an agreed fair market value of $2.8 million, a tax basis to Times of $1.5 million, and thus an inherent gain to Times of $1.3 million.

Teruya acquired Kupuohi I ("KI") and Kaahumanu ("K") from Times in exchange for Royal Towers and $0.7 million cash. Immediately before the exchange, Royal Towers had a fair market value of $11.9 million, a tax basis to Teruya of $0.7 million, and thus an inherent gain to Teruya of $11.2 million. K had an agreed fair market value of $3.7 million, a tax basis to Times of $1.5 million, and thus an inherent gain to Times of $2.2 million. KI had an agreed fair market value, as agreed between Teruya and Times, of $8.9 million, a tax basis to Times of $15.6 million, and thus an inherent loss to Times of $6.7 million.

As shown in the summary table below, Teruya exchanged properties having a fair market value of $13.3 million, a tax basis of $0.8 million, and an inherent gain of $12.5 million, plus $2.1 million in cash, for Times’ properties having a fair market value of $15.4 million, a tax basis of $18.6 million, and an inherent loss of $3.2 million (inherent loss on KI of $6.7 million, net of $3.5 million inherent gain on K and KII).

Teruya treated the transaction as two different exchanges. In the first, Teruya transferred Ocean Vista in exchange for Kupuohi II and paid

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4. The tax-avoidance exception in section 1031(f)(2)(C) applies to multi-party exchanges, the taxpayer did not establish that tax avoidance was not one of the principal purposes of the transaction. Fifth, a “tax planning” motive does not remove the transaction from section 1031(f)(4) where the tax planning seeks to achieve objectives prohibited by section 1031(f)(4).

56. The exchanger parent corporation in Teruya Brothers owned 62.5% of the only class of stock of the subsidiary. Thus, the parties were not eligible to file a consolidated tax return. Even if they did file a consolidated return, the like-kind exchange rules in Treas. Reg. § 1.1502-80(f) would not have applied because the exchange occurred before July 12, 1995 (the effective date of the regulations).

57. Approximate numbers are used throughout, unless otherwise noted.
$1.366 million cash to Times. The properties had the following respective values and bases at the time of the exchange.

**Ocean Vista Exchange**

<table>
<thead>
<tr>
<th></th>
<th>Ocean Vista</th>
<th>KII</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>$1,438,000</td>
<td>$2,828,000</td>
</tr>
<tr>
<td>Teruya’s basis</td>
<td>($93,000)</td>
<td>Times’ basis</td>
</tr>
<tr>
<td>Inherent gain</td>
<td>$1,345,000</td>
<td>Inherent gain</td>
</tr>
</tbody>
</table>

In the second transaction, Teruya transferred Royal Towers in exchange for Kupuohi I and Kaahumanu and paid $0.7 million in cash. The properties had the following respective values and bases at the time of the exchange.

**Royal Tower Exchange**

<table>
<thead>
<tr>
<th></th>
<th>Royal Towers</th>
<th>KI</th>
<th>K</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>$11,900,000</td>
<td>$8,900,000</td>
<td>$3,700,000</td>
</tr>
<tr>
<td>Teruya’s basis</td>
<td>($700,000)</td>
<td>Times’ basis</td>
<td>($15,600,000)</td>
</tr>
<tr>
<td>Inherent gain</td>
<td>$11,200,000</td>
<td>Inherent gain</td>
<td>($6,700,000)</td>
</tr>
</tbody>
</table>

Based on these figures, Teruya and Times were facing the following tax consequences, if section 1031 did not apply.

**Respective Gain/Loss Situation**

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
<th>Gain/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Teruya</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ocean Vista</td>
<td>$1,438,000</td>
<td>$93,000</td>
<td>$1,345,000</td>
</tr>
<tr>
<td>Royal Towers</td>
<td>$11,900,000</td>
<td>$700,000</td>
<td>$11,200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$2,066,000</td>
<td>$2,066,000</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$15,404,000</td>
<td>$2,895,000</td>
<td>$12,545,000</td>
</tr>
</tbody>
</table>
As a result of these transactions, the relative property and cash positions of Teruya and Times changed, as follows.

**Changes in Aggregate Position**

**Property-Cash Position Before**

<table>
<thead>
<tr>
<th></th>
<th>Teruya</th>
<th></th>
<th></th>
<th>Times</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FMV</td>
<td>Basis</td>
<td>Gain/Loss</td>
<td>FMV</td>
<td>Basis</td>
<td>Gain/Loss</td>
</tr>
<tr>
<td>Ocean Vista</td>
<td>$1,438,000</td>
<td>$93,000</td>
<td>$1,345,000</td>
<td>$2,828,000</td>
<td>$1,475,000</td>
<td>$1,353,000</td>
</tr>
<tr>
<td>Royal Towers</td>
<td>$11,900,000</td>
<td>$700,000</td>
<td>$11,200,000</td>
<td>$3,700,000</td>
<td>$1,500,000</td>
<td>$2,200,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$2,066,000</td>
<td>$793,000</td>
<td>$12,545,000</td>
<td>$2,066,000</td>
<td>$793,000</td>
<td>$12,545,000</td>
</tr>
<tr>
<td>Total</td>
<td>$13,338,000</td>
<td>$793,000</td>
<td>$12,545,000</td>
<td>$15,428,000</td>
<td>$18,575,000</td>
<td>$(3,147,000)</td>
</tr>
</tbody>
</table>

**Property-Cash After**

<table>
<thead>
<tr>
<th></th>
<th>Teruya</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FMV</td>
<td>Basis</td>
<td>Gain/Loss</td>
</tr>
<tr>
<td>KII</td>
<td>$2,828,000</td>
<td>$1,459,000</td>
<td>$1,369,000</td>
</tr>
<tr>
<td>K</td>
<td>$3,700,000</td>
<td>$1,500,000</td>
<td>$2,200,000</td>
</tr>
<tr>
<td>KI</td>
<td>$8,900,000</td>
<td>$15,600,000</td>
<td>$(6,700,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$15,428,000</td>
<td>$18,575,000</td>
<td>$(3,147,000)</td>
</tr>
</tbody>
</table>

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58. This figure is 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.

59. This figure is the sum of the $700,000 basis of Royal Towers plus $700,000 in cash paid to Times multiplied by the fraction of $3,700,000 (fair market value of K) over $12,600,000 (the total fair market value of K and KI).
Related Party Exchanges

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>$15,428,000</th>
<th>$2,859,000</th>
<th>$12,569,000</th>
<th>$0</th>
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</thead>
<tbody>
<tr>
<td>Times Cash</td>
<td>FMV</td>
<td>Basis</td>
<td>Unreal’d Gain/Loss</td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$15,404,000</td>
</tr>
<tr>
<td>Combined After</td>
<td>FMV</td>
<td>Basis</td>
<td>Unreal’d Gain/Loss</td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$15,428,000</td>
<td>$2,859,000</td>
<td>$12,569,000</td>
<td>$15,404,000</td>
<td></td>
</tr>
</tbody>
</table>

In round numbers, the Times-Teruya group decreased its investment property position by $13.4 million ($28.8 million minus $15.4 million after), and equally increased its cash position by $13.4 million ($15.4 million after minus $2.0 million before), as a result of the exchanges.

Teruya consummated the two exchanges through a QI in 1995. Times recognized its $3.5 million gain on the sale of K and KII (less expenses). Times realized approximately $6.7 million loss (plus expenses) on the sale of KII. Times did not claim the $6.7 million loss on KI because of the section 267(f)(2)(B) deferral on recognition of corporate losses on sales to related corporations.61 Almost ten years later, as of the date Teruya Brothers was decided, Teruya still owned KII, K and KI.

After reviewing the relationship between sections 1031(f)(1), 1031(f)(2)(C), and 1031(f)(4), the Tax Court determined that Teruya had used the multi-party structures to avoid the consequences of economically equivalent direct exchanges with Times. It inferred that the QI was interposed in an attempt to circumvent the section 1031(f)(1) limitations that would have applied to exchanges directly between related persons. The court concluded that Teruya had failed to establish that avoidance of federal income taxes was not one of principal purposes of the exchange. The court emphasized that the economic substance of the transactions was the cash-out of the investments in Ocean Vista and Royal Towers with Times, a related person, ending up with the cash proceeds.

60. This figure is the sum of the $700,000 basis of Royal Towers plus $700,000 in cash paid to Times multiplied by the fraction of $8,900,000 (fair market value of K) over $12,600,000 (the total fair market value of K and KI).

61. Treas. Reg. §1.1031(k)-1(f)(4)(i) states that “the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a),” but does not mention section 267. Further, there is case law support for applying section 267 where title to the property is temporarily held by even an uncontrolled unrelated party, where the substance of the prearranged plan is to maintain continuous economic and practical control of the depreciated-in-value property in the related party group. See McWilliams v. Comm’r, 331 US 694 (S. Ct. 1947); Merritt v. Comm’r, 400 F2d 417 (5th Cir. 1968); Stara and Shoemaker, The Tax Implications of Being a Related Party Under Sec. 267, 6-91 THE TAX ADVISER 390 (June 1991). Thus, Times’ position that section 267(f)(2)(B) deferred recognition of its KI loss is supportable.
Accordingly, the Tax Court held that section 1031(f)(4) disqualified Teruya’s 1995 exchanges from section 1031(a)(1) nonrecognition. As a consequence, the court concluded that Teruya’s realized gains of $1.3 million on Ocean Vista and $11.2 million on Royal Towers were recognized in 1995, leading to a 1995 tax deficiency against Teruya of more than $4 million.

In considering whether the transaction came within section 1031(f)(4), the Tax Court stated 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.” The plain language of this statement indicates the court merely looked at the before and after aggregate property-cash positions of Teruya and Times. This language does not indicate that the court considered whether there was any abusive basis shifting in the subject transaction. Instead, the court introduced the comparative tax price analysis.

C. The Comparative Tax Price Analysis

The Tax Court’s comparative tax price analysis asks whether an exchange and a subsequent disposition change the exchanger’s and related party’s aggregate property-cash position and then compares the tax the exchanger attempts to defer under section 1031 to the tax price incurred by the related party on the transaction. Under the analysis, if there is a cash-out and the related party incurs a tax price that is lower than the tax the exchanger defers, the transaction does not qualify for section 1031 nonrecognition. Although commentators, the Senate Report, and the IRS appear to focus on basis shifting and cashing out, the Tax Court in Teruya Brothers appears to ignore those concepts and focus instead on tax price. Unfortunately, the Tax Court does not provide sufficient factual information to allow for sufficient probing of its application of the comparative tax price analysis. In the absence of such facts, this article assumes certain facts for the sake of analysis.

1. The Tax Court’s application of the comparative tax price analysis

The Tax Court applied the comparative tax price analysis by comparing Teruya’s tax deferred to Times’ current tax price. Because KI was loss property and Times had unused operating loss to offset the gain from K and KII, it paid no tax on the transfers in the year of exchange. Because Times paid no tax for the year of the exchange, the Tax Court appeared to conclude that its tax price was less than the tax Teruya deferred. This summary conclusion failed to explore adequately the concept of the comparative tax price analysis, leaving open the possibility that the Tax Court applied it incorrectly.
2. **The definition of tax price**

To correctly apply the comparative tax price analysis, tax price must be defined. The Tax Court appeared to adopt a definition of tax price that looks only at the exchanger’s deferred gain for the year of the exchange and the related party’s tax liability for that year. Times offset losses with gain it recognized, however, and deferred loss recognition on the transaction under section 267(f)(2)(B), both of these may carry a tax price. Furthermore, other nuances not considered by the Tax Court, such as tax rate disparity and timing differences, may also create a tax price differential.

a. **The tax price of loss offset**

Teruya’s gain of $1.3 million (before selling expenses) on Ocean Vista was perhaps larger than the gain Times would have recognized had Times and Teruya exchanged properties and Times had then sold Ocean Vista. The Tax Court focused on Times’ 1995 corporate tax return, which showed a $1 million net operating loss, even after Times reported $1.3 million of taxable gain from the Ocean Vista transaction. Thus, the Tax Court in *Teruya Brothers* might have allowed nonrecognition to Teruya if Times did not have offsetting losses.

The opinion does not indicate whether Tax Court considered that the $1.3 million reduction of Times’ net operating loss carryforwards from 1995 in applying its tax price analysis. The offsetting of the loss carryforwards is the economic equivalent of eventually paying tax on the gain since the reduced loss carryovers will require Times to pay tax on income sooner than would have been the case if the Times had not recognized the gain. However, the Tax Court may have felt justified in ignoring loss carryforward reductions because of the speculative nature of post-exchange-year income, and the time value of the exchange-year tax savings 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).

Conversely, the opinion fails to address the result that would have obtained if Times could have carried back the entire $2.3 million 1995 loss (if it had not recognized the gain of $1.3 million) to offset income in earlier taxable years on which Times had paid regular corporate tax. If the $1.3 million gain reduced a loss that Times would otherwise be able to carry back, Times did incur a tax price by recognizing gain. The court likely failed to consider this because Teruya did not present any evidence to this effect.

The IRS in TAM 200126007 stated that the goal of the related party like-kind exchange was “avoiding current tax.” This statement
perhaps suggests that the IRS concluded that Teruya knew that Times had a projected 1995 loss at the time of the exchange, that such loss was not available for carryback, and that Teruya's knowledge of Times' projected 1995 net operating loss was indeed an important aspect of the IRS's conclusion that the section 1031(f)(2)(C) exception did not apply. Alternatively, the IRS may have concluded that an exchange's impact on past and future years' tax liabilities carry less weight than the impact on the current year's tax liability in determining whether tax avoidance was a motive, despite the fact that losing a loss carryback or carryforward may have significant tax consequences. It is more likely that the exchanger failed to present evidence of the tax cost incurred by Times in the exchange.

Thus, an exchanger might argue that any loss carryforwards to its exchange year, and any loss carrybacks from its exchange year that it can show are projected by the exchanger at the time of the exchange should nullify the existence of a tax avoidance plan.62

b. The tax price of tax bracket disparity

The tax price to both the exchanger and related party can be affected by each party’s respective tax bracket. For example, suppose a exchanger controls a charity and thus is related to that charity under section 267(b)(9). Suppose the exchanger exchanges property with the charity, which then disposes of the property within the two-year time period. Even if the charity's property had a low basis, which low basis is transferred to the exchanger's former property under section 1031(d), the charity could avoid inclusion of the 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 case, 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 basis, the comparative tax price analysis would not require the exchanger to recognize the gain realized on the exchange.

c. Tax price of timing differences

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

62. Section 172(b)(1)(A)(1) generally limits loss carrybacks to two years.
focuses only on the year of the exchange and does not take into account the
time value of money, makes little economic sense. The IRS in FSA 200137003 acknowledges that section 1031(f)(1) and section 1031(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). Thus, an exchanger could argue that it
is not the hypothetical tax liability of the exchanger on a direct exchange to
an unrelated party that should be viewed as the exchanger’s “tax price.”
Instead, the comparative tax price analysis should arguably consider the net
present value of the overall tax consequences to the exchanger group.

For example, as mentioned above, the statement in Rev. Rul. 2002-
83 that the related party did not recognize gain indicates that tax avoidance
motivated the parties.63 The ruling does not address the situation where the
related party recognized gain. Thus, it is unknown whether gain
recognition by the related party would compel the opposite conclusion—that
tax avoidance did not motivate the exchange. If the related party
recognizes gain on the transaction in excess of the gain the exchanger
defers, the IRS would find it much more difficult to argue that the
exchanger and related party structured a series of transactions to effect a
basis shift and tax-free cash-out. This focus reflects a gross tax savings
approach, which the court in Teruya Brothers appeared to adopt.

As the discussion above foreshadows, a gross tax savings approach
may not be appropriate. Instead, the appropriate approach would consider
the net present value of tax savings, if a related party gain is offset by
losses that could be carried forward or carried back. For example, suppose
a exchanger has a zero basis property worth $1 million, and a related party
has a property with a $1 million basis and $1.2 million value. The
exchanger exchanges its property and $200,000 in boot with the related
party, who then sells that property for $1 million. The exchanger and
related party are both in the 30% tax bracket. The exchanger could
distinguish Rev. Rul. 2002-83 by observing that $0.2 million boot gain is
triggered to the related party with a resultant tax liability of $60,000. The
exchanger could argue that it is inappropriate to compare the $60,000 tax
generated to the $300,000 tax saved by the exchanger by using a like-kind
exchange instead of a direct sale to find a tax-avoidance motive, similar to
the approach taken in Teruya Brothers. The exchanger could note that the
related party could have waited two years to sell the exchanger’s property,
in which case there would have been no tax to the exchanger under FSA 200137003.

If section 1031(f) does not apply, then by disposing of the property
immediately rather than in two years, the related party was able to have the

63. See supra note 49.
use of the exchanger's $300,000 deferred tax immediately rather than in two years. At an interest rate of approximately 6% applicable to tax underpayments, the net savings to the exchanger is about $36,000, less than the $60,000 tax generated by the boot payment, which may or may not be sufficient to support a finding of no tax avoidance. An argument that relies for its appeal upon actions that the related party might have taken, rather than actions that actually were taken, would in all likelihood be vigorously rejected by the IRS for its lack of administrability. Further, a court may be understandably reluctant to render judgments based upon possibilities, rather than actualities.

D. Sections 1031(f)(1)-1031(f)(4) Overlap

1. Does section 1031(f)(1) apply to indirect exchanges?

The plain language of section 1031(f)(1) suggests that it only applies to direct exchanges between related parties and not to multi-party exchanges or exchanges facilitated by an intermediary. Teruya did not exchange directly with Times; rather, Teruya transferred Ocean Vista and Royal Towers to an unrelated acquirer through a QI and directed the QI to use the exchange proceeds to acquire KII, K and KI for Teruya from Times. The Tax Court in *Teruya Brothers* considered whether section 1031(f)(1) may apply without a direct exchange between the exchanger and related party. Such consideration is important because the IRS has applied section 1031(f)(1) to multi-party, intermediary-facilitated exchanges.64

In PLR 9525037, the IRS cautioned the exchanger that if within two years after an indirect exchange with a related party through a QI, section 1031(f)(1) could apply to trigger gain in the year of subsequent disposition. If section 1031(f)(1) did not apply, however, the IRS’s only means of attacking the exchange would have been through section 1031(f)(4). The distinction between the two is important because under a section 1031(f)(1) attack, the exchanger recognizes gain during the year of the subsequent disposition, but under a section 1031(f)(4) attack, the exchanger recognizes gain in the year of exchange.

The IRS may have used this distinction to its advantage in FSA 199931002,65 in which the exchanger engaged a QI to facilitate an exchange. The exchanger transferred relinquished property to an unrelated party and directed the acquirer to transfer the sales proceeds to a QI, which used the proceeds to acquire replacement property from a party related to the exchanger. Within two years after the exchange, the exchanger disposed of the property acquired from the related party. The IRS determined that since the exchanger sold that replacement property within

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64. See, e.g., TAM 200126007 and FSA199931002, discussed infra.
two years after the exchange “in contravention of the requirements of section 1031(f)(1)(C)” section 1031(f)(1) applied, and the exchanger was required to recognize gain from the exchange in the taxable year of the subsequent disposition.66

In PLR 200251008,67 the IRS applied a similar interpretation of section 1031(f)(1) to a build-to-suit exchange involving a related party. The transaction clearly was not a direct exchange between the exchanger and related party,68 yet the IRS claimed that section 1031(f)(1) applied, stating: “Since both Taxpayer and the related parties continue to be invested in the exchange properties, and are not otherwise cashing out their interest, [section] 1031(f)(1) is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that was part of the exchange.” Citing section 1031(f)(1), it also stated that “[t]he proposed transaction is a parking transaction between related parties.”

In contrast, in PLR 200440002,69 the IRS stated that section 1031(f)(1) did not apply, but rather section 1031(f)(4) could apply, to a related-party exchange carried out through a QI, because the exchange occurs through the QI, not directly with the related party. The Tax Court also appeared to accept this position in Teruya Brothers, albeit in a footnote. In footnote 10, the court concluded that the IRS “appears to acknowledge implicitly that [section] 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 QI is not considered the agent of the taxpayer for purposes of [section] 1031(a).”

2. Significance of the scope of section 1031(f)(1)

This split in authority raises an interesting question: does a footnote in a Tax Court opinion, which refers to an action the IRS does not take and which would not help it to take, and a more recent private letter ruling carry greater weight than an earlier field service advice and private letter ruling? While the resolution of this question regarding the relative

66. The facts in FSA 199931002 do not state that the statute of limitations had tolled on the year of the exchange, but they do state that the year of the exchange was not under examination. Further, the fact that statute of limitations had tolled on the year of the exchange may be inferred from the fact that the IRS first concluded that the transaction violated section 1031(f)(4) and later concluded that it also violated section 1031(f)(1).
68. In that transaction, a related party leased real property to an exchange accommodation titleholder (“EAT,” as defined in Rev. Proc. 2000-37, 2000-2 C.B. 308. See Bryant and Allitzer, Guidance From the IRS on Making Reverse – Starker Exchanges, 79 TAXES 16 (Feb. 2001)) that constructed improvements on the property. In an exchange facilitated by a QI, the taxpayer transferred its relinquished property in exchange for the leasehold and improvements from the EAT.
weight of authority is a low stakes issue, the resolution of the substantive law question whether section 1031(f)(1) applies to an indirect exchange can be significant. For example, suppose the exchanger sells the replacement property within two years after the exchange. If the statute of limitations has run on the earlier year of the exchange, thereby thwarting the IRS’s use of section 1031(f)(4),\(^7\) or the exchanger is in a higher marginal tax bracket in the later year of the sale, the use of section 1031(f)(1) to trigger gain recognition in the later year may produce a larger tax liability. Deferral of the gain recognition date under section 1031(f)(1), as compared to section 1031(f)(4), may also change from long-term to short-term any post-exchange appreciation in value recognized on a second disposition within 12 months of the original exchange.\(^7\) Thus, the applicability or non-applicability of section 1031(f)(1) to an indirect exchange though a QI, the most common form of exchange, is an issue that deserves closure.

Allowing the IRS to choose which subsection to apply to an exchange would give it the opportunity to determine the year for which it will assess a deficiency. This flexibility provides uncertainty regarding the statute of limitations, and so undermines the policy of the statute of limitations, which is to provide certainty and closure to tax years. This also allows the IRS to compare the tax consequences that would result if it applied section 1031(f)(1) to the tax consequences that would result if it applied section 1031(f)(4), and assess tax in the year that provides that generates the largest amount of tax due. Since there is no discussion of this possibility in the section 1031(f) legislative history, one could surmise that Congress did not intend this result. Indeed, the plain language of both section 1031(f)(1) and section 1031(f)(4) suggests that they apply exclusively to direct and indirect exchanges, respectively.

While the Tax Court’s footnote may be nothing more than low-level dictum, it is comforting to see the IRS apparently retreat from the illogical application of section 1031(f)(1) to indirect exchanges. An attempt to apply section 1031(f)(1) to anything other than a direct exchange where the exchanger disposes of the replacement property within two years after the exchange generally produces bizarre results. PLR 200251008 is an example of such a result: the related party did not hold exchange property following the exchange that it could dispose of. Furthermore, the exchanger took a substituted basis in the leasehold and the improvements. A subsequent disposition of that property by the exchanger would cause recognition of the deferred gain. Thus, not only is the application of section 1031(f)(1) to an indirect exchange not involving the sale of the replacement property illogical, it is also of little, if any, utility.

\(^7\) The IRS must generally assess tax within three years after a tax return due date, unless the omission of an item results in a substantial understatement. See I.R.C. § 6501.

\(^7\) Commentators have questioned how post-exchange depreciation deductions are to be dealt with under section 1031(f)(1). See Fellows and Yuhas, Like-Kind Exchanges and Related Parties Under New Section 1031(f), 68 TAXES 352 (May 1990).
3. Relevance of subsequent sale

Teruya Brothers is distinguishable from FSA 199931002 because in Teruya Brothers, the exchanger did not sell the replacement property within two years after the exchange. Indeed, as of the date of the Teruya Brothers decision, almost ten years after the exchange, Teruya still held KII, K and KI. Thus, in Teruya Brothers, unlike FSA 199931002, the applicability of section 1031(f)(1) versus section 1031(f)(4) had no practical significance. This appears to leave room for the IRS to argue for the applicability of section 1031(f)(1) in other indirect exchange cases.

If the statement in the Teruya Brothers’ footnote 10 applies to all indirect exchanges, the question would arise as to whether section 1031(f)(4) would apply to the fact pattern in PLR 9525037 if one of the parties subsequently transferred one of the exchange properties. If section 1031(f)(1) does not apply, section 1031(f)(4) should remain applicable, as it did in Teruya Brothers, for at least two years, to prevent the subsequent tax-free cash out of one of the properties. If the exchanger and related party used a QI to circumvent the time-of-recognition rule in section 1031(f)(1), then they should be required to recognize gain under the section 1031(f)(1) rule, not the section 1031(f)(4) rule. The act of circumventing section 1031(f)(1) should subject them to the section 1031(f)(1) rule; however, it is also the case that the exchange was structured to avoid the purposes of section 1031(f), which can lead the IRS to conclude that section 1031(f)(4) should apply.

E. Bifurcating Exchanges

In Teruya Brothers, Teruya acquired all its replacement properties from Times. If Teruya had acquired some of its replacement property from unrelated parties, the Tax Court could have faced the difficult decision whether and how to bifurcate Teruya's exchange. In the transaction described in Teruya Brothers, Teruya transferred, through a QI, Royal Towers, valued at $11.9 million, plus $0.7 million of cash boot, in exchange for Times' KI property valued at $8.9 million plus Times' K property valued at $3.7 million. Suppose, however, that instead of Teruya acquiring K from Times for $3.7 million, Teruya acquired another like-kind property from an unrelated party for $3.7 million. Could Teruya successfully argue that its exchange be bifurcated and the unrelated party acquisition enabled $3.7 million of its exchange to qualify under section 1031(a)(1)?

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72. See Borden, Lederman, and Spear, supra note 53, for a discussion of bifurcating exchanges.  
See also Levine, supra note 53, at sec. II.D.5.b.
An argument against bifurcation is that section 1031(f)(4) applies to any exchange which is a part of a series of transactions designed to avoid the purposes of section 1031(f) and that the statute in no way explicitly provides for any partial qualification of a disqualified exchange. Thus, the acquisition of KI from Times should taint the entire Royal Towers exchange, so that even the $3.7 million in property acquired from an unrelated party was not deferrable by Teruya; i.e., acquiring a portion of the replacement property from an unrelated party should not change the result of complete recognition of Teruya's $11.2 million Royal Towers gain. Although this draconian result would serve no evident policy purpose, it appears to follow from the plain language of the statute.

Under the continued investment theory, Teruya would have continued its investment in like-kind property acquired from an unrelated party, and Times would have continued its investment in K. Since there was no cashing out with respect to the $3.7 million investment in K and Royal Towers, there was no abuse as to that piece of the transaction and Teruya arguably should not be required to recognize gain on that part of the transaction. Bifurcating the exchange to achieve this result, however, would only require identifying the values of the properties acquired from the unrelated party and the related party and a relative simple computation to allocate the basis of the relinquished property to each part of the exchange.73

Bifurcation under section 1031(f) would require that other questions be answered. For example, what did Teruya transfer in exchange for Times’ property and in exchange for the unrelated party’s property? The IRS could argue that the Teruya transferred its highest basis-to-value property (the $0.7 million cash and 25% of Royal Towers) to the unrelated party. In that event, bifurcation would reduce Teruya's gain on Royal Towers recognized by 25% of the $11.2 million of Royal Towers' appreciation, or $2.8 million, to $8.4 million. Teruya, on the other hand, would prefer to allocate the lowest basis-to-value properties to the $3.7 million property acquired from the unrelated party. If this were possible, Teruya could argue that it should be treated as if it acquired the unrelated party's property for a 31% interest in Royal Towers ($3.7 million replacement property from the unrelated party divided by $11.9 million value of Royal Towers). In that event, bifurcation would reduce Teruya's gain recognized by 31% x $11.2 million appreciation in Royal Towers, or $3.5 million, to $7.7 million.

Still another approach would allocate the $3.7 million value of the unrelated party’s property pro-rata based on the value of all the properties exchanged. If this is the correct result, Teruya exchanged $0.7 million cash

73. This computation is already used to allocate basis when property is sold in lots. See Williford, Sinnett, Tax Planning for the Developer: Allocating Costs Among Land and Improvements, 103 J. TAX’N 335 (December 2005).
(6% of the consideration) and $11.9 million value in Royal Towers (94% of the consideration), and Teruya's $3.7 million acquisition from the unrelated party would be in exchange for a $3.5 million interest in Royal Towers (94% x $3.7 million) and $0.2 million of cash (6% x $3.7 million). Teruya's deferrable gain on $3.5 million value of Royal Towers would be $3.5 million x $11.2 million gain / $11.9 million value, or $3.3 million. That is, under a pro-rata approach, Teruya could reduce its gain on Royal Towers by $3.3 million, to $7.9 million. Other allocation methods are possible, and the analysis would differ if the Ocean Vista exchange were aggregated with the Royal Towers exchange.

IV. ESTABLISHING LACK OF TAX-MOTIVATED PURPOSE

In *Teruya Brothers*, the Tax Court ruled that the exchanger did not present evidence sufficient to show that section 1031(f)(2)(C) did not apply to the transaction. Section 1031(f)(2) disregards certain types of subsequent dispositions if the dispositions are not abusive. First, under section 1031(f)(2)(A) and (B), it disregards subsequent transfers at death and through involuntary conversions are disregarded. Second, under section 1031(f)(2)(C), subsequent dispositions that do not have tax avoidance as a principal purpose are disregarded. Because the applicability of section 1031(f)(2)(A) and (B) is relatively clear, most issues of interpretation concern the applicability of section 1031(f)(2)(C).

Section 1031(f)(2)(C) provides: “[T]here 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.”

74. Section 453(e) contains similar language. See I.R.C. § 453(e)(7) (2006) (“This subsection shall not apply to a second disposition (and any transfer thereafter) if it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax.”). Congress anticipated that Treasury “would provide definitive rules so that complicated legislation is not necessary to prescribe substituted property or taxpayer rules which would not be of general application. In appropriate cases, it is anticipated that the regulation and ruling under the nontax avoidance exception will deal with tax-free transfers which normally would not be treated as a second disposition of property, e.g., charitable transfers, like-kind exchanges, gift transfers, and transfers to a controlled corporation or partnership. Generally it is intended that a second disposition will qualify under the nontax avoidance exception when it is of an involuntary nature, e.g., foreclosure upon the property by a judgment lien creditor of the related purchaser or bankruptcy of the related purchaser. In addition it is intended that the exception will apply in the case of a second disposition which is also an installment sale if the terms of payment under the installment sale are substantially equivalent to, or longer than, those for the first installment sale. However, the exception would not apply if the resale terms would permit significant deferral of recognition of gain from the initial sale when proceeds from the resale are being collected sooner.” See S. Rep. 96-1000, supra note 27 at 16. Although Treasury has not adopted regulations, the IRS appears to have accepted the nontax avoidance transaction in the Senate Report. See I.R.S. Form 6252, *Installment Sale Income* (2006) (providing that the nontax avoidance exception generally applies to the second disposition if it is involuntary or an installment sale). See also Edward J. Roche, Jr., *Satisfying the Secretary: Demonstrating Lack of Tax Avoidance Motivation in Related Party Installment Sales*, 5
Thus, a key issue is what type of evidence must a exchanger present to demonstrate that tax avoidance was not one of the principal purposes of the exchange and subsequent disposition? Possible evidence a exchanger may present to demonstrate lack of tax-avoidance purpose includes: (1) innocuous (none-abusive) subsequent dispositions, (2) lack of pre-arranged plan, (3) exchange without tax advantage, (4) separation of exchanges, (5) initial sale to unrelated party, (6) lack of control of the related party, (7) non-tax business purpose, and (8) related-party exchange as a last resort. Examining each of these factors with a view to the purposes of sections 1031(a)(1) and 1031(f) sheds light on whether any of them should be considered as sufficient evidence to establish the lack of tax-motivated purpose.

A. Innocuous Subsequent Dispositions

The legislative history to section 1031(f)(2)(C) posits a number of non-abusive dispositions to which the non-tax avoidance exception will generally apply. The Senate Finance Committee Report on section 1031(f)(2) states that:

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 the entire interest in a single property or a large[r] undivided interest in any of such properties; (ii) dispositions of property in nonrecognition transactions; and (iii) transactions that do not involve the shifting of basis between properties.\footnote{75}{See S. Prt. No. 56, supra note 38.}

1. Exchanges of undivided interests

This exception concerning aggregation of fractional interests may be justified on the grounds that, generally, consolidations of fractional interests are not principally tax-motivated, and even in situations where they are, the "generally" qualification permits the IRS to deny section 1031(f)(2)(C) relief. This fractional-interests exception was applied in PLR 9550021\footnote{76}{Sep. 15, 1995.}76 and FSA 199926045\footnote{77}{Apr. 2, 1999.}77 and is confirmed by the instructions to the 2006 IRS Form 8824.\footnote{78}{Available at http://www.irs.gov/pub/irs-pdf/f8824.pdf. Last visited April 15, 2007.} The IRS described the effect of this exception to the facts of the FSA as follows:

\begin{itemize}
\item VA. TAX REV. 91 (1985) (discussing various potential nontax avoidance related party installment sale transactions).
\end{itemize}
The proposed transaction between Taxpayer and [related] Corp is an exchange of undivided interests. Essentially, this will be a partition of jointly-owned property enabling each party, as sole owners of their respective parcels, to determine whether to hold, use or dispose of the property. The legislative history of section 1031(f)(1) indicates that Congress did not intend for this subsection to apply to a subsequent disposition under these circumstances. Therefore, any disposition by [related] Corp of its interests will not trigger application of section 1031(f)(1) because the exchange between Taxpayer and [related] Corp qualifies under section 1031(f)(2)(C).

2. Subsequent section 1031 exchanges

In PLR 200616005 and PLR 200440002 the IRS ruled that a series of two interrelated exchanges qualified for section 1031(a)(1) nonrecognition. In those rulings the exchanger transferred relinquished property to an unrelated party and acquired replacement property from a related party through a QI. The related party structured the transfer of its property to the exchanger as part of a section 1031 exchange, acquiring other like-kind replacement property from an unrelated party through a QI. In PLR 200440002, where neither the exchanger nor the related party cashed-out, the IRS found that the transaction did not implicate section 1031(f)(4) and qualified for section 1031(a)(1) nonrecognition. The IRS did not explicitly refer to the economic substance test, but the ruling is consistent with this test.

In PLR 200440002, the exchanger and related party only received like-kind property. The economic positions of the parties were the same before and after the exchange: i.e., they both held like-kind property, and the cash position of both remained the same. Viewed another way, PLR 200440002 is consistent with the "before and after" test, since the exchanger and related party remain fully invested in like-kind property after the related party's disposition of the exchanger's property. PLR 200616005 represents an extension of PLR 200440002, by admitting the possibility that the exchanger could receive some boot in the related-party exchange, but indicating that the exchanger's gain recognized is limited to the boot.

Two private rulings, PLRs 200616005 and 200440002, are consistent with the legislative history to section 1031(f) stating that

79. Id.
dispositions through nonrecognition transactions qualify under section 1031(f)(2)(C).\textsuperscript{82} Because a subsequent section 1031 exchange enables the exchanger and related party to continue investments in like-kind property, such dispositions should be evidence that neither the exchange nor the subsequent disposition had a tax-motivated purpose.\textsuperscript{83}

The release of PLRs 200616005 and 200440002 has raised the question as to whether the 45 day identification period in section 1031(a)(3)(A) can in effect be extended by identifying a related party's property within forty-five days, acquiring the related party's property within 180 days, and thereby starting another forty-five day identification period in the hands of the related party. Some commentators have argued that PLR 200440002 "arguably provides for an extension of time to acquire replacement property [which] is why a related party property should always

\textsuperscript{82.} This is also consistent with the legislative history to the section 453(e)(7) non-tax-avoidance exception for second dispositions of property purchased in a related party installment sale which indicates that second dispositions that are like-kind exchanges or other nonrecognition exchanges should not trigger gain under section 453(e). S. Rep. No. 96-1000, supra note 27. Similarly, the Senate Report indicates that second dispositions that are themselves installment sales should not disqualify the original sale to the extent the second installment note remains outstanding (that is, to the extent the related party does not cash out). \textit{See also} Raby, \textit{Raby, Related Parties, Tax-Deferred Sales, and Cashing Out}, 2005 TNT 32-162 (Feb. 17, 2005) (arguing that a second disposition that is a like-kind exchange should qualify for the tax-avoidance exception under section 1031(f)(2)(C) because the taxpayer would have been entitled to section 1031(a)(1) nonrecognition if it hypothetically engaged in the second like-kind exchange without the earlier related-party exchange having occurred). The instructions to the 2006 IRS Form 8824 likewise ordinarily except a subsequent section 1031 exchange from characterization as a disqualifying second disposition for purposes of section 1031(f)(4).

\textsuperscript{83.} Following the subsequent section 1031 exchange, the property received in that exchange should be treated as exchange property and remain subject to the section 1031(f)(1) two-year holding period requirement. \textit{Teruya Brothers} seems to support the view that a taxpayer who transfers relinquished property to a related party through a QI and uses the proceeds to acquire replacement property from an unrelated party avoids the application of section 1031(f). In \textit{Teruya Brothers}, the Tax Court, using an economic equivalence test, tested a related-party exchange transaction undertaken through a QI in which the taxpayer's property was ultimately disposed of outside the related party group as if the taxpayer first directly exchanged with the related party (i.e., as if \textit{Teruya} exchanged Ocean Vista, Royal Towers, and cash for Times' KII, K and KI properties), and then the second disposition (the deemed cash sale within two years of Ocean Vista and Royal Towers by Times) was undertaken. Applying this economic equivalence approach to section 1031(f) to the acquisition by the taxpayer of like-kind property from an unrelated party, the deemed second disposition could be viewed as a hypothetical like-kind exchange by the taxpayer within two years of the replacement property acquired from the related party. As discussed below, such like-kind kind exchanges seem to be excised from having a tax-avoidance purpose under section 1031(f)(4), due to the absence of basis shift and cash-out. Thus, section 1031(a)(1) seems to be available where the taxpayer transfers relinquished property to a related party through a QI and uses the proceeds to acquire replacement property from an unrelated party. The IRS has privately ruled that such like-kind kind exchanges does not have a tax-avoidance purpose under section 1031(f)(4), due to the absence of basis shift and cash-out. I.R.S. Priv. Ltr. Rul. 200709036 (Nov. 28, 2006). Section 1031(a)(1) should therefore be available to an exchanger who transfers relinquished property to a related party through a QI and uses the exchange proceeds to acquire replacement property from an unrelated party. \textit{See also} I.R.S. Priv. Ltr. Rul. 200712013 (Mar. 23, 2007) (ruling privately there was not tax avoidance purpose under section 1031(f)(4) where the exchanger purchased like-kind replacement property from an unrelated third party via an exchange accommodation titleholder, and then sold the relinquished property to a related party for exchange proceeds received by a qualified intermediary).
be identified as a third alternative property."\textsuperscript{84} Other commentators have concluded that "where evidence exists that the [related party] replacement was motivated by the need to extend the identification and replacement periods, the holding of PLR 200440002 cannot be relied on."\textsuperscript{85}

3. Other subsequent tax-free dispositions

The section 1031(f)(2)(C) legislative history indicates that subsequent tax-free transfers of exchange property to corporations\textsuperscript{86} or partnerships,\textsuperscript{87} are evidence that tax-avoidance was not a principal purpose of the exchange and subsequent disposition. This recognizes that both the exchanger and related party remain invested in property before and after the exchange and subsequent disposition, thus satisfying the purpose of section 1031. This is similar to the position the Ninth Circuit took in \textit{Magneson v. Commissioner}, wherein it stated, "The central purpose of both [section] 721 and [section] 1031(a) . . . 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 in the old investment still unliquidated.’"\textsuperscript{88} The court "decline[d] to read in [section] 1031(a) the requirement that the taxpayer continue to hold the acquired property in the exact form of ownership in which it was acquired. So long as . . . the taxpayers continue 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)."\textsuperscript{89} Viewing the subsequent tax-free transfer of property to a corporation or a partnership as a mere change in the form of ownership and not a liquidation of the investment indicates that such transfers are evidence of lack of tax-avoidance purpose.

4. Subsequent gifts

\textsuperscript{84} Levine, "Recent Developments Affecting Like-Kind Exchanges Under §1031," 47 TAX MGM’T. MEMO. No. 6 (March 20, 2006).
\textsuperscript{85} Hammill, \textit{Prepare for IRS Attack on Indirect Related-Party Exchanges}, 77 PRAC. TAX STRAT. 260 (November 2006).
\textsuperscript{86} See I.R.C. § 351.
\textsuperscript{87} See I.R.C. § 721.
\textsuperscript{88} 753 F.2d 1490 (9th Cir. 1985) (granting section 1031 nonrecognition to an exchanger who exchanged property under section 1031 and then contributed it to a general partnership in exchange for a general partnership interest). The subsequent transfer of property to a partnership or corporation raises issues regarding the section 1031(a)(1) holding and use requirements. For an in-depth discussion of exchanges followed by business transactions, see Borden, \textit{Section 1031 and Proximate and Multistream Business Transactions}, 19 TAX MGM’T REAL ESTATE J. 307 (November 5, 2003).
\textsuperscript{89} 753 F.2d 1490 at 1496-7.
Commentators have also recommended that the section 1031(f)(2)(C) non-tax-avoidance safe harbor should apply to a subsequent disposition by gift. The subsequent gift, however, deprives either the exchanger or related party of property. Thus, this fact does not support the argument that the transaction should qualify for section 1031(a)(1) nonrecognition under the continued investment theory. Because the exchanger and related party donee have the same aggregate property position as they did before the exchange and gift, though they do satisfy the absence-of-cash-out rationale.

If, however, a related party (or even an unrelated party donee such as an uncontrolled charity) sells the exchanged property in connection with its receipt of the gift, this could raise concerns under section 1031(f) and related doctrines. For example, in some cases involving a pre-arranged sales by a donee, the donee’s gain has been reallocated back to the donor under assignment-of-income principles. If a donee’s sale is reallocated back to the donor, that could trigger application of section 1031(f) to the exchanger.

Even if the gift is not a prohibited subsequent disposition under section 1031(f)(1)(C), a gift made shortly after the receipt of the gifted property in a like-kind exchange may cause the donor to be viewed as lacking the requisite investment intent and thus disqualify the exchange as to the donor under section 1031(a)(1). Thus, for example, if the related party makes a gift of the exchanger’s former property immediately after acquiring it in exchange for the related party’s property, then the related party could be required to recognize its gain by reason of lack of the requisite intent with respect to the property it received.

B. Lack of Pre-Arranged Plan

In a pre-section 453(e) ruling, Rev. Rul. 73-536, a taxpayer sold appreciated property on an installment basis to her husband. At the time of the taxpayer’s sale, it was the intention of her and her husband that she would resell the property in order to obtain funds to meet her husband’s separate obligations.

90. Fellows and Yuhas, supra note 71.
92. Click v. Comm’r, 78 TC 225 (1982), aff’d in unpublished opinion (4th Cir, 1982) (holding that a mother’s exchange of farm for two residences did not qualify under section 1031; her two children moved into the residences immediately and she formally gifted the residences to them seven months later). Cf. Wagensen v. Comm’r, 74 TC 653 (1980) (holding that the intent to make an eventual gift of the ranch received, which developed shortly after the exchange, does not disqualify the exchange from section 1031 nonrecognition). This same lack of intent issue, of course, must be considered in other contexts involving subsequent purportedly tax-free dispositions of property within two years, such as those in Magnuson, supra note 89. See generally Fogel, How Long Must Like-Kind Exchange Properties be Held?, 2006 TNT 186-35 (Sep. 26, 2006).
93. 1973-2 CB 158.
Rev. Rul. 73-356 states that there was no pre-arranged plan of purchase between an unrelated third party buyer and the taxpayer and her husband at the time of the taxpayer's sale to her husband. However, four months after the purchase, the husband did sell for cash the property that he had purchased from his wife.

Rev. Rul. 73-356 held that the exchanger was taxable on her husband's gain on the sale of the property. Applying a conduit theory, Rev. Rul. 73-356 held that the intention of closely related parties to resell the property after the original transaction is considered strong evidence that the original transaction lacks substance, and that the related party is acting as the exchanger's agent. In a later, pre-section 453(e) case, Nye v. United States,94 however, the District Court allowed installment sale treatment for a sale of marketable stock by a wife to her husband even though resale by the husband was contemplated at the time of the first sale.

The legislative history of section 453(e), after mentioning Nye, states "the committee believes that the application of the judicial decisions, involving corporate liquidations, to intra-family transfers of appreciated property has led to unwarranted tax avoidance by allowing the realization of appreciation within a related group without the current payment of income tax."95

Thus, it seems arguable that for purposes of section 453(e), and by analogy for purposes of section 1031(f)(2)(C), a prohibited plan should be found in all cases where the exchanger and related party, at the time of the exchange by the exchanger and related party, have the common intention that the related party will sell the exchanger's property within two years, even if no buyer has been located at the time of the exchange. If this is the test, it is arguable that a related party's decision to sell within the two year period, for reasons other than those contemplated by the exchanger and related party at the time of the related party's exchange with the exchanger, absolves the exchanger under section 1031(f)(2)(C). Some support for this view can be found in sections 1031(f)(2)(A) and 1031(f)(2)(B), which exempt sales after death and through an involuntary conversion. In those cases, Congress is in effect not imputing the intent of the related party's executor, or the government agency condemning the related party's property, to the exchanger and related party, presumably because of the lack of any economic relationship between them.

Tecumseh Corrugated Box Co. v. Commissioner,96 the only judicial authority interpreting section 453(e)(7), does not contradict this view. There, the courts apparently found that one of the primary purposes of the exchanger's installment sale of realty to a related party was an...
impending sale of that realty to a third party, which sale in fact occurred six months later. The courts noted such indicia of common intent as the use of the same attorney to represent the exchanger and related party in the continuing sale negotiations with the third party. The common intent having been found, the Tax Court viewed the section 453(e)(7) exception for non-tax-avoidance plan narrowly to encompass transactions such as second non-taxable exchanges, which were not present under the facts of *Tecumseh Corrugated Box Co*.

C. Exchanges without Tax Advantage

The Senate Finance Committee Report on section 1031(f)(2)(C) also targets basis shifting for the purpose of a cash out, noting that “it is intended that the non-tax-avoidance exception generally will apply for . . . transactions that do not involve shifting of basis between properties.”

Indeed, the IRS believes that section 1031(f)(4) is addressed to basis shifts, for the purpose of cashing out, as indicated in Rev. Rul. 2002-83, which clearly illustrates the use of basis shifting to cash out. This view is confirmed in the instructions to 2006 IRS Form 8824. The instructions to the form state that related-party exchanges will “generally” be excused from section 1031(f)(4) recognition by reason of a lack of a tax-avoidance purpose where “the related parties derive no tax advantage from the shifting of basis between the exchanged properties.” Therefore, one way to establish non-tax-avoidance motive is to demonstrate that no taxpayer advantageous basis shifting has occurred. The lack of basis shift might not, however, be the only way to establish non-tax-avoidance motive. For example, if, in *Teruya Brothers*, Times hypothetically did not have losses available to shelter its gain on KII but rather was in the same tax bracket as Teruya, the Tax Court apparently would have allowed Teruya non-recognition on the Ocean Vista plus boot for KII exchange on a tax-price-based analysis of the non-tax-avoidance exception.

The Tax Court looked only at Times’ tax bill for the taxable year involving Teruya’s exchange. This raises the question of whether the Tax Court would have found that the Ocean View exchange did qualify for section 1031(f)(2)(C) protection, if Times could have presented objective evidence of, or a reasonable subjective belief that, Times’ entire loss for the year of the exchange was unexpected and related to the 8-month portion of Times’ taxable year following the exchange. Such evidence would establish that, at the time of the exchange, Times and Teruya did not intend to reduce their aggregate tax liability for that year.

D. Separation of Exchanges

Since section 1031(f)(4) disqualifies any exchange that is part of a series of transactions designed to circumvent section 1031(f), the question
of when an exchange should be integrated or instead separated from other exchanges is an important issue. For example, in *Teruya Brothers*, both Teruya's Ocean Vista and Royal Towers exchanges, when viewed separately, were held to violate section 1031(f)(4). Suppose, however, that the Tax Court had hypothetically accepted Teruya's argument that the Ocean Vista transaction, when viewed separately from Teruya's Royal Towers transaction, was not taxable under section 1031(f)(4) because, unlike Teruya's Royal Towers transaction, Times' recognized gain on the exchanged property exceeded Teruya's potentially deferrable gain. (In *Teruya Brothers*, this argument was rejected because of Times' net operating losses). The IRS might have presented the fall-back argument, that even if Teruya's Ocean Vista exchange was not described in section 1031(f)(4) if viewed separately, the Ocean Vista transaction was a part of a series of transactions, encompassing both the Ocean Vista and Royal Towers exchanges. Ocean Vista and Royal Towers exchanges were closed within eight days of each other, using the same QI and Times participated in both exchanges. Thus, since the Tax Court found Teruya's Royal Towers exchange was designed to avoid the purposes of section 1031(f), the IRS could argue that that Teruya's Ocean Vista exchange, being part of the same series of transactions, was necessarily likewise disqualified.

Nevertheless, Teruya could argue that if the Ocean Vista exchange, if viewed separately, was determined to be outside the scope of section 1031(f)(4), there is no policy reason to apply section 1031(f)(4) to that exchange merely because the Royal Towers exchange was disqualified. Moreover, the Tax Court, in *Teruya Brothers*, did seem to test the Ocean Vista and Royal Towers exchanges separately. Further, the Royal Towers disposition was negotiated by Teruya with an unrelated party not involved with Ocean Vista. Therefore, the better view would have been to permit the otherwise qualifying related-party exchange involving Ocean Vista to be treated separately from the Royal Towers exchange, which was disqualified under section 1031(f)(4).

E. Initial Sale to Unrelated Party

Some commentators have suggested the possibility that the result in *Teruya Brothers* could conceivably be avoidable in a limited number of cases where the exchanger could establish that the QI acquiring the related party's relatively high-basis property was engaged for a non-tax business purpose and that such QI had enough substance so as to not to be viewed as the exchanger's agent under federal income tax principles outside the qualified intermediary safe harbor.97

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The same function could be fulfilled by a non-QI independent party pursuing its own objectives. For example, suppose that, in *Teruya Brothers*, before the sale of Ocean Vista and Royal Towers, Times, to raise needed money for its debt obligations, sold KII, K, and KI for cash to an unrelated large real estate investment fund. Alternatively, suppose Teruya bought KII, K and KI for cash from Times, and then resold KII, K and KI for cash to an unrelated real estate investment fund. Assume that the fund had no binding obligation to resell KII, K and KI to Teruya's QI as replacement property, a put against Teruya, or any other contractual agreement relating to KII, K and KI with Teruya, Times, or any other party related to Teruya. Suppose, however, that at the time the fund acquired the property, Times and Teruya hoped that the fund would resell KII, K and KI to Teruya through a QI as replacement property for Teruya's expected later dispositions of Ocean Vista and Royal Towers. Suppose that, in hindsight, the fund did resell the property to Teruya as replacement property and a price not significantly greater than the amount the fund paid Times. Could Teruya have argued that the independent decision of the fund to resell KII, KII and K to Times defeated the application of section 1031(f)(4)?

In interpreting the "like-kind" requirement of section 1031(a)(1), PLR 7823035\(^{98}\) favorably permitted a cash sale to an unrelated buyer to avoid integration with a subsequent exchange. The IRS position, as set forth in Rev. Rul. 67-255,\(^{99}\) is that a building constructed on land already owned by the taxpayer is not like-kind to the taxpayer's converted land. In PLR 7823035, the exchanger sold its raw land for cash, and pursuant to prearranged plan, and indeed apparently even pursuant to a written agreement, the buyer of the land built a building on that land and then swapped the land and newly constructed building for other real estate owned by the exchanger. PLR 7823035 favorably held that the cash sale to the unrelated buyer would not be integrated with the later exchange for purposes of section 1031(a)(1). The IRS did not consider the application of Rev. Rul. 67-255, since it was not discussed in the ruling, or it simply was not viewed as applicable, and the exchanger was entitled to non-recognition treatment.

More generally, "parking arrangements," involving purchases of property by unrelated third parties who are expected to resell the purchased property to the exchanger, are often suggested as a means of satisfying section 1031(a)(1) while avoiding the strict time limits of the IRS reverse exchange safe harbor.\(^{100}\)

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99. 1967-2 CB 270 (applying the like-kind standard of section 1031 pursuant to a condemnation of real property under section 1033(g)).
In Rev. Rul. 72-354\textsuperscript{101}, involving a corporate reorganization, the IRS ruled that the exchanger's sale of stock to an unrelated third party for cash, which third party did not grant a call to, nor obtain a put from, the exchanger, blocked the application of the integrated step transaction doctrine. Rather, the subsequent exchange of that property with the exchanger by the unrelated property was, favorably to the exchanger, to be tested for non-recognition independently from the unrelated party's cash purchase of the property from the exchanger and earlier transactions involving that property, such as cash purchases of that property by the exchanger.

On the other hand, section 1031(f)(4) itself only requires for its application that a series of transactions be "structured to avoid the purposes of this subsection." The Senate Committee Report on section 1031(f)(4) illustrates this by referring to a situation where a "prearranged plan" involving an unrelated party exists, without discussing the issue of enforceable agreements with the unrelated party.\textsuperscript{102} Rev. Rul. 2002-83 states broadly that "if an unrelated third party is used to circumvent the purposes of the related party rule in [section] 1031(f), the non-recognition provisions of [section] 1031 do not apply to the transaction." Therefore it is doubtful whether the absence of a binding agreement between the unrelated party and the exchanger would necessarily preclude the application of section 1031(f)(4).

Rev. Rul. 77-414\textsuperscript{103} involved an installment sale by the taxpayer to an unrelated financial institution, coupled with a sale by that unrelated financial institution to a third party desiring to buy the exchanger's former property for cash. The IRS denied the taxpayer installment sale treatment. Rev. Rul. 77-414 noted the existence of an "arrangement," perhaps meaning a pre-existing commitment by the third party to buy the taxpayer's former property from the unrelated financial institution. TAM 8738001\textsuperscript{104} seems, however, to conclude the rationale of Rev. Rul. 77-414 was the absence of a business purpose for the taxpayer to use the unrelated financial institution, in the sense that the third party was willing to buy the property for cash from the taxpayer. The IRS's stress on lack of business purpose as the basis of Rev. Rul. 77-414 suggests that it would not view the interposition of an unrelated fund to buy the related party's high-basis property sufficient to block the application of section 1031(f), at least where the exchanger, at the time of the unrelated fund's purchase, could have purchased the related party's property directly.

The modified before-and-after comparison is also consistent with not permitting a exchanger to block application of section 1031(f) merely

\textsuperscript{102} See S. Prt. No. 56, supra note 38.
\textsuperscript{103} 1977-2 CB 299.
\textsuperscript{104} Mar. 4, 1987.
because, for some length of time, beginning and ending within the two year period, the related party's relatively high basis property was owned outside the exchanger-related party group. As long as that property winds up being owned by the exchanger within the two year period, pursuant to the exchanger's and related party's plan at the time of the exchanger's exchange, section 1031(f) should arguably apply.

If section 1031(f) is deemed applicable, however, other issues arise. For example, under a modified before-and-after approach, any amount paid by the exchanger to the unrelated third party to reacquire the property from outside the group in excess (or less than) of the amount that the third party paid the related party should offset (or increase) the exchanger's gain.

F. Lack of Control of Related Party

In Rev. Rul. 73-536, one of the revenue rulings expounding the conduit theory underlying section 453(e), the IRS focused on the common intention of the taxpayer (wife) and related party (husband) that the taxpayer would resell the property in order to obtain funds to meet the related party's obligations. The reliance on joint exchanger-related party motive as the basis for denying installment sale treatment may leave room for exchangers to argue by extension that lack of common control should qualify the transaction under section 1031(f)(2)(C), even though two parties come within the technical definition of related parties. Since the definition of related party in section 267(b) is so broad, two parties who deal only at arms-length may come within the definition of related party, even though they do not have a common purpose or common control. One example of this is adult siblings who operate economically in a completely separate manner, such that an exchange between the adult siblings could separate the benefits of cashing out from those of exchanging the property. To the extent that the parties do not control each other, section 1031 arguably is not being used abusively; yet in the case of the adult siblings, while they do not control one another or function as an economic unit like spouses, they could easily plan an exchange in such a way as to benefit each other.

Moreover, even within the section 1031(f)(3) definition of related party, two entities may not be subject to the same locus of control. For example, suppose that the real estate businesses of Teruya and Times had been managed by a completely different group of executives and board members. Suppose the Teruya management group did not know that Times’ tax basis as a fraction of value in KII, K, and K1 was higher than the corresponding basis-to-value ratio for Teruya’s Ocean Vista and Royal Towers’ properties or that Times expected a large net operating loss for its 1995 year. Times could then argue that tax avoidance was not its principal purpose so the exception under section 1031(f)(2)(C) applied.
As another example, suppose that Teruya and Times had been two sister companies (rather than parent - subsidiary) with no other relationship described in section 1031(f)(3) except that a majority of Times’ shares were owned by one sibling and a majority of Teruya’s shares were owned by another sibling. Suppose that for genuine business reasons, Teruya wanted to buy KII, K, and KI at the price offered by Time, and to dispose of Ocean Vista and Royal Towers to an unrelated party to fund the purchase of KII, K, and KI. Suppose that Teruya was aware of Times’ relatively higher basis to value ratio in KII, K, and KI than Teruya’s basis-to-value ratio in Ocean Vista and Royal Towers, and of Times’ expected large net operating loss for its 1995 year. Since neither Teruya nor Teruya’s stockholders in this example would have received any benefit from receipt of the tax-sheltered cash exchange proceeds by Time, a colorable argument could be made that the section 1031(f)(2)(C) exception should apply to Teruya.  

On the other hand, the IRS could point out that courts have applied section 267(b) attribution without regard to family hostility. Therefore, the IRS may argue that once the section 267(b) relationship is established, any transaction that causes a tax-saving basis shift between that related person and the exchanger cannot qualify for the section 1031(f)(2)(C) exception, no matter how hostile or attenuated that relationship is.

G. Non-Tax Business Purpose

The IRS in TAM 200126007 and the Tax Court in Teruya Brothers held that once the IRS established that the relationship test of section 1031(f)(3) was met by reason of Teruya’s majority ownership of Times, Teruya’s exchange was subject to testing under section 1031(f), even if Teruya and its related party acted at arm’s length in the subject transaction. Nevertheless, the IRS in TAM 200126007, unlike the Tax Court, appeared willing to favorably consider the presence of some non-tax business purposes of Teruya and Times in deciding whether a section 1031(f)(2)(C) principal purpose of federal income tax avoidance existed. The IRS ruled, however, that the exchange was driven by the desire to reduce the exchanger’s tax liability. The IRS stressed the business benefit to Teruya of Times’ approximate $4 million of tax savings on the selling price that would have been paid by Teruya had Teruya sold Royal Towers and Ocean Vista directly, paying tax on the gain before buying KII, K, and KI from Times. The IRS, unlike the Tax Court, pointed out that in addition to

105. Cf. Brittingham v. United States, 598 F.2d 1375 (5th Cir. 1979) (viewing sister corporations, each controlled by a different sibling, as not having a common tax-avoidance motive under section 482 because of adverse economic interests).

106. Metzger Trust v. Comm’r, 693 F.2d 459 (5th Cir. 1982), aff’d 76 TC 42 (1981). See also supra Section II.A. (discussing the significance of the definition of related party).
Teruya’s majority ownership of Times, the two families that owned the stock of Teruya also directly owned additional stock in Times. The IRS stated that Teruya’s and Times’ objective in devising the plan was to avoid current tax on the disposition of Ocean Vista and Royal Towers. The IRS found as a factual matter that the transaction was structured so that Times could in effect obtain untaxed cash from Teruya to be used for paying Times' debts.

In *Tecumseh Corrugated Box Co.*, the Sixth Circuit held out that under the analogous rule of section 453(e)(7), the presence of any principal tax-avoidance purpose caused the related party rule to apply. *Tecumseh Corrugated Box Co.* held that even assuming, without deciding, that the exchanger also had a labor law reason for the sale to a related party, the existence of a principal tax avoidance purpose caused acceleration of tax to the exchanger upon the related party's resale.

H. Related-Party Exchange as Fall-Back Alternative

Some practitioners argue that an exchanger should be able to utilize section 1031(f)(2)(C) if the exchanger decides to acquire replacement property from a related party only after unsuccessfully attempting to acquire replacement property from an unrelated party.\(^\text{107}\) This situation may occur where the exchanger identifies a related party’s property as “safety” property to be acquired only in the event that the exchanger is unable to acquire “first-choice” or “second-choice” property from an unrelated party. Although not raised in the Tax Court’s opinion, TAM 200126007 may indicate that the IRS is willing at least to consider this argument. In the TAM, the IRS stresses that “there is no indication that the Taxpayer [Teruya] ever contemplated acquisition of replacement property other than the property of the Related Party [Times] property; it executed a letter of intent for the purchase of some of the properties before negotiating the sale of its relinquished property.” The example in the House Report identifying a series of transactions structured to avoid the purposes of section 1031(f)(1) specifically refers to a pre-arranged plan. This language implies that contemplating or planning an exchange with an unrelated party may be important in establishing a non-tax-avoidance motive.

If the exchanger sells relinquished property through a QI to an unrelated party with no preference at that time to acquire replacement property from the related party, the exchanger could argue that it did not contemplate the subsequent acquisition from the related party and that it was not part of a pre-arranged plan. The facts in Rev. Rul. 2002-83 do not refer to a pre-arranged plan, yet because the exchanger considered no replacement property other than that owned by the related party and

\(^{107}\) See Levine, *supra* note 53.
identified only that property in the exchange agreement, it seems clear that the IRS believed there was a pre-arranged plan under the facts of that ruling. The failure of the ruling to address the existence of a plan may indicate that the IRS did not wish to confine the application of a ruling to only those situations where an examining agent could easily identify a pre-conceived plan. Perhaps, however, the best approach to analyzing the ruling is to assume that the IRS believes that any time high basis replacement property is acquired from a related party (directly or indirectly), there is a pre-arranged plan to acquire it. The burden in such a situation would be on the exchanger to show a lack of a pre-arranged plan, a seemingly difficult burden to satisfy.

The basic requirements for implementing a deferred like-kind exchange militate heavily against the possibility of such an argument. Fulfilling the statutory and regulatory requirements for a deferred like-kind exchange require planning and deliberation. The regulations limit the number of alternative properties (generally three properties or any number not exceeding 200% of the value of the relinquished properties) be designated in writing as replacement properties within forty-five days after the transfer of the relinquished property, as required by section 1031(a)(3). The exchanger identifying property owned by a related party creates written evidence that the exchanger very seriously considered, if not fully intended, to acquire the related party’s property. Even if the related party’s property is the least preferred alternative, the exchanger’s act of identifying it demonstrates deliberation, if the exchanger ultimately acquires the related party’s property.

Further, the regulations do not require any prioritization among the identified properties in a situation where not all of the properties could be acquired with the exchange proceeds. Thus, a written identification meeting the requirements of the regulations would show an intent to acquire replacement property from a related party, but generally would not provide any indication of the exchanger’s preference among the identified properties. Moreover, even if the exchanger were to indicate a prioritization among the identified properties, this act could easily be dismissed as a self-serving attempt to negate the existence of a plan to acquire the related party replacement property.

Even if the exchanger could show that the plan to acquire related party property was developed after the disposition of the exchanger’s property, section 1031(f)(2)(C) requires that the “exchange” lack a principal tax avoidance motive. A deferred “exchange” spans the time period beginning with the disposition of the relinquished property and

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108. See also Cuff, Related-party exchanges – An Examination of Technical Advice Memorandum 9748006, 26 J. REAL ESTATE TAX’N 155 (1999) (“There is no apparent basis – other than wishful thinking – for the taxpayer’s argument that the forbidden purpose must exist at the time at which he entered into the agreement to dispose of the relinquished property.”).

ending with the acquisition of the replacement property. Thus, the IRS and the courts would be unlikely to agree that a primarily tax-motivated acquisition from a related party is excepted by the application of section 1031(f)(2)(C) merely because the tax-motivated plan is developed and implemented after the transfer of the relinquished property.

Lastly, although it is possible that a seller may withdraw an identified property from the market or unexpected problems with an identified property (such as the discovery of environmental contamination) may arise that cause the exchanger to reject the property, there is also the potential for the exchanger to manipulate the process by refusing to negotiate in good faith with the unrelated sellers. In summary, if the exchanger acquires that property, it may be difficult for the exchanger to establish that it did not contemplate or preplan buying replacement property from a related party.

I. Scope of Section 1031(f)(2)(C)

Prior to the Teruya Brothers decision, questions arose as to whether the non-tax avoidance exception applied only to section 1031(f)(1) two-party direct exchanges and did not apply to section 1031(f)(4) multi-party exchanges. The Tax Court in Teruya Brothers established its view that because the section 1031(f)(2)(C) “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)(1) should also take this exception into consideration.” Thus, the Tax Court views section 1031(f)(2)(C)’s scope to be broad enough to apply to section 1031(f)(4) transactions.

J. Limitation of Gain

If an exchange with a related party is only in part a cash-out, should section 1031(f)(2)(C) be interpreted to apply only to part of the transaction? Viewed another way, should section 1031(f) be interpreted, at least in cases in which the related parties are all in the same tax bracket, to avoid duplicative acceleration of gain?

Suppose, contrary to fact, that in Teruya Brothers, Teruya swapped $0.7 million in cash and a 25% co-ownership interest in Royal Towers worth $3 million, basis of $0.2 million, and appreciation of $2.8 million in exchange for K, having a fair market value of $3.7 million and unrealized appreciation of $2.2 million. Suppose further that Times held the 25% co-

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110. See Officials Discuss Recent and Future Guidance on Exchanges, 98 TNT 96-14 (May 19, 1998) (IRS official notes a possible inconsistency between section 1031(f)(2)(C) and section 1031(f)(4)). The article reviews comments of Kelly Alton (an author of this article), then counsel to the assistant chief counsel, income tax and accounting division, Office of Chief Counsel, IRS National Office.
ownership interest in Royal Towers for investment until it sold that interest within the two year period.

At the time of the exchange, Times would recognize $0.7 million of boot. Times' 25% co-ownership interest in Royal Towers would have a basis to Times of $2.2 million ($0.7 million gain recognized plus $1.5 million basis carried forward from K), and an unrealized appreciation to Times of $1.5 million ($3 million value minus $1.5 million basis).

Teruya's basis in K would be $0.9 million ($0.7 million boot paid plus $0.2 million carried over from Teruya's 25% co-ownership interest in Royal Towers). Teruya's unrealized appreciation in K would be $2.8 million ($3.7 million value minus $0.9 million basis.)

Suppose there were no other relevant transactions between Teruya and Times and that Times, like Teruya, had no net operating losses and was otherwise in the same tax bracket as Teruya. For simplicity's sake, ignore Times' depreciation on Royal Towers. Suppose also that within two years Times sold its 25% co-ownership interest in Royal Towers for $3 million, triggering to Times its unrealized appreciation in its 25% co-ownership interest in Royal Towers of $1.5 million. Under the general rule of section 1031(f)(1), Teruya would recognize gain of $2.8 million.

In theory, the section 1031(f)(2)(C) exception should apply to the $2.2 million portion of the transaction that was not a tax-free cash-out (i.e., the total amount of gain Times recognized on the exchange and subsequent disposition). The theoretically preferable approach would have been for Teruya to have recognized only $0.6 million of gain, not the full $2.8 million of gain that a literal application of section 1031(f)(1) would provide. Times would recognize its $0.7 million boot received at the time of the exchange of K to Teruya, and recognize $1.5 million on Times' sale of its 25% co-ownership interest in Royal Towers to a third party. Under this theoretical approach, Teruya would step up its basis in K by $0.6 million Teruya recognizes under section 1031(f)(1) to $1.5 million, and thereby reduce Teruya's unrealized appreciation to $2.2 million.

Thus, under the theoretical approach, the Teruya-Times group recognizes the same cumulative amount of gain, $2.8 million, that Teruya would have recognized had it sold its 25% co-ownership interest in Royal Towers to the third party directly; Times recognizes $0.7 million at the time of the exchange with Teruya; Times recognizes $1.5 million of gain when Times sells its 25% co-ownership interest in Royal Towers to the third party; and Teruya recognizes $0.6 million under section 1031(f)(1), as limited by section 1031(f)(2)(C), when Times sells its 25% co-ownership interest in Royal Towers to the third party. The remaining $2.2 million of gain will be recognized by Teruya when Teruya disposes of K.

The limited gain recognition to the exchanger and related party over time reaches the same $5 million of gain within the Teruya-Times group that would obtain had Teruya not engaged in a like-kind exchange
with Times but rather they had sold a 25% co-ownership interest in Royal Towers and K to unrelated parties for cash.

The limited gain recognition approach is consistent with the modified before-and-after approach. In the above example, Times' sale of its 25% co-ownership interest acquired from Teruya results in the group's disposition of property which, in Teruya's hands, had an inherent gain of $2.8 million and a value of $3 million, and substitutes for that the $3 million cash Times receives from a third party. Thus, the cumulative gain recognized under the limited gain approach is the $2.8 million the group properly recognizes from replacing Teruya's property having a $2.8 million appreciation with an equal value in cash.

Viewed another way, the limited gain recognition approach avoids a basic unfairness in the all-or-nothing approach of section 1031(f) that can result, in effect, in double acceleration of the related party's appreciation on its high basis property at the time of the related party's sale of the exchanger's property. First, that gain is triggered in the related party's hands under the general rule of section 1001. Second, that gain is in effect triggered to the exchanger under section 1031(f) because the exchanger must recognize the gain attributable to the relative appreciation in the exchanger's exchanged low basis property in excess of the gain attributable to the relative appreciation in the related party's high basis property (the related party's tax-avoidance type reduction of gain through basis shifting. gain), in addition to any remaining appreciation in its exchanged property, including that attributable to its relative appreciation that is no greater than the relative appreciation in the related party's high basis property (the related party's reduction of gain having nothing to do with basis shifting).

Section 1031(f)(4), as drafted, however, does not explicitly allow limited gain recognition, which would require coordination as to the amount of gain recognized between the related parties. Although the statute mandates gain recognition only as to the exchanger, which in the foregoing example would be Teruya, since there is also an exchange as to Times, from Times' perspective as an exchanger, there has also been a disposition which requires Times to recognize the unrealized appreciation on the exchange of K. In the absence of a limited gain approach, Teruya and Times would have recognized, upon Times' sale of the 25% co-ownership interest in Royal Towers received in exchange from Teruya, $2.8 million and $2.2 million, respectively.

The limited gain recognition approach finds support in the section 453(e) model after which section 1031(f) was fashioned. Section 453(e) provides that if a sale of property to a related party is reported under the installment method, a subsequent disposition of the property by the transferee related party will trigger accelerated gain recognition to the transferor. Gain is accelerated by treating the transferor as receiving the
amount realized by the transferee on the second disposition. Under section 453(e), the transferor is treated as receiving only the amount realized by the transferee on the subsequent disposition. Thus, if the transferee transfers only a portion of the property in a subsequent disposition, the transferor will be deemed to receive only a portion of the total installments due from the related party. In other words, the subsequent disposition of a portion of the transferred property does not trigger gain recognition with respect to the entire transferred property. Section 1031(f) is silent about the possibility of bifurcating a section 1031 transaction involving a related party. Nonetheless, the same principle should in theory apply to like-kind exchanges involving related parties, given the relationship between the two statutes and the similarity of their aims.

V. PROCEDURAL ISSUES

Procedural issues presented by the section 1031(f)(2)(C) exception presently faced by practitioners include: (1) What information must be disclosed for an exchanger seeking to claim the benefits of section 1031(f)(2)(C) on its IRS Form 8824 (“Like-Kind Exchanges”)?; (2) Would the IRS consider issuing a private letter ruling that a transaction comes within the scope of section 1031(f)(2)(C)?; and (3) What standard of review would courts impose on the IRS’s finding that it is not satisfied that the exchange or disposition lacks a principal purpose of tax avoidance? The Tax Court in Teruya Brothers dealt with only the last issue, and even then only in a superficial manner.

A. IRS Form 8824 Reporting

Exchangers must file an IRS Form 8824 to report like-kind exchanges. The 2006 IRS Form 8824 states that a exchanger who exchanges property with a related party, either directly or indirectly, such as through acquisition from a QI, is required to file Form 8824 for the year of the exchange and the two succeeding years. The exchange with the related party must be specifically identified. If the exchanger or related party has disposed of the exchange property within the two years following the exchanger’s exchange, the parties must report that transfer as triggering a gain, unless an applicable exception applies. If the exchanger claims that

111. I.R.C. § 453(e)(1).
113. The Form 8824 and instructions were modified in response to comments submitted by the ABA Tax Section and The Real Estate Roundtable. See ABA Members Request Exemption of Like-Kind Exchanges from Tax Shelter Reporting Regs, 2003 TNT 37-14 (February 25, 2003); Real Estate Group Proposes Amendments to Like-Kind Exchange Form to Identify Abuses, 2003 TNT 45-48 (Mar. 7, 2003).
the section 1031(f)(2)(C) tax-avoidance exception applies, the exchanger must attach an explanation of that claim. The uncertainty as to the scope of the tax-avoidance exception illustrated by Teruya Brothers suggests that the IRS may scrutinize these explanations.114

B. IRS Private Letter Ruling Availability

Presently, Rev. Proc. 2007-3115 which governs the IRS no-rulings area, does not include section 1031(f)(2)(C) as a no-rulings area. In PLR 200440002, the IRS held that in the case of a direct exchange otherwise described in section 1031(f)(1), a second disposition that is itself a like-kind exchange does not trigger the exchanger’s gain. PLR 200440002 cites section 1031(f)(2)(C) for its conclusion, thus indicating that the IRS does entertain ruling requests based on the non-tax-avoidance exception of section 1031(f)(2)(C).116

On the other hand, there are general policy considerations that might preclude an exchanger from being eligible to obtain a private letter ruling as to the applicability of section 1031(f)(2)(C). Since section 1031(f)(2)(C) depends on the exchanger’s tax-avoidance purposes, the IRS could decline to issue a private letter ruling by analogy to section 3.01(24) of Rev. Proc. 2007-3, which makes the question of whether a corporate acquisition is not tax-motivated under section 269 a no-rule area.117

In addition, section 3.02(1) of Rev. Proc. 2007-3 states that private letter rulings are not issued on transactions that “have as their principal purpose the reduction of federal taxes.” On the other hand, an exchanger whose ruling request is rejected under this provision could well have expected an adverse ruling on the substantive issue of qualification under section 1031(f)(2)(C) in any event. The ultimate outcome of a taxpayer’s request for a private letter ruling relying upon the non-tax-avoidance exception of section 1031(f)(2)(C) will likely depend upon whether the objective characteristics of the exchange sufficiently demonstrate a lack of a tax avoidance purpose and the existence of a business purpose for the exchange to enable the IRS National Office to feel comfortable that the

114. The instructions to 1995 IRS Form 8824 applicable to Teruya likewise required a taxpayer who exchanged property in 1995 with a related party to file Form 8824 for the year of the exchange specially reporting the exchange as a related-party exchange. The 1995 IRS Form 8824, like the 2006 IRS Form 8824, mentioned section 1031(f)(4), and required a statement if the taxpayer claimed the section 1031(f)(2)(C) non-tax-avoidance exception. The instructions to 1995 IRS Form 8824, unlike the instructions to 2006 IRS Form 8824, did not specifically refer to indirect exchanges made through a QI.

115. 2007-1 IRB 108.

116. See PLR 199926045 (ruling privately that section 1031(f)(2)(C) applies to related-party exchanges necessary to create separate wholly owned tracts of old growth timber; legislative history cited as evidence of Congressional intent to allow the exchange to qualify under section 1031(f)(2)(C)); see also PLR 200541037 (ruling similarly).

117. PLR 9126007 (Mar. 27, 1991) (failing to rule privately on section 1031(f)(2)(C) issue by analogy to no-ruling policy on section 269 issues).
taxpayer does not have a hidden tax avoidance motive for undertaking the related-party exchange.

C. Standard of Review

The standard of judicial review of the IRS’s determination that the exchanger does not qualify for the section 1031(f)(2)(C) tax-avoidance section is also somewhat unclear. Some commentators have concluded that since section 1031(f)(2)(C) requires that non-tax-avoidance be established to the satisfaction of the Secretary, the “abuse of discretion” standard should apply. Under this standard, in order to prevail, an exchanger must prove that the Commissioner exercised his discretion arbitrarily, capriciously, or without sound basis in fact or law.

In *Teruya Brothers*, however, the Tax Court observed that its standard of review of IRS determinations under Code provisions with similar language, at least for examinations, such as that in *Teruya Brothers*, that began before the July 22, 1998, effective date of section 7491, is that the exchanger must only show “strong proof.” “Strong proof” is a somewhat lower standard than “arbitrary and capricious,” but a somewhat higher standard than “preponderance of the evidence.” Nevertheless, because the Tax Court stated that the standard of proof made no difference to the outcome, it did not apply any heightened standard of proof beyond the customary burden of proof placed on the exchanger.

The standard of review of the analogous provision of section 453(e)(7) was discussed by the Sixth Circuit in *Tecumseh Corrugated Box Co.* The court observed:

> The Senate Finance Committee Report on this provision [section 453(e)(7)] summarized it as follows: "The resale rules will not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes." S. Rep. No. 1000, 96th Cong., 2d Sess. 16 (1980). The Senate Report acknowledged that 453(e)(7) "puts [the] taxpayer at a disadvantage if he or she should seek a court ruling on the merits of the issue." *Id.* at 17. Thus, the Committee "accepted the . . . legislation only with the specific understanding that

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121. See Tax Court Rule 142.
. . . the Commissioner shall treat taxpayers fairly and equitably in light of all the facts and circumstances of each particular case in a manner consistent with the remedial intent of the preceding sections . . . .” Id. at 17-18 . . .

The Senate Report advised that the non-tax exception should be limited to "exceptional cases" and "would not apply if the resale terms would permit significant deferral of recognition of gain from the initial sale when proceeds from the resale are being collected sooner." 122

The impact of section 7491 on the standard of judicial review of adverse IRS determinations under section 1031(f)(2)(C), for examinations commencing on or after its July 22, 1998 effective date, is unclear. Section 7491(a) permits certain taxpayers, subject to net worth limitations in the case of entities, to shift the burden of proof to the IRS by introducing credible evidence. Section 7491(a) does not, however, shift the burden of proof if the taxpayer fails to substantiate any item required to be substantiated by the Code to the satisfaction of the Secretary, or if the section involved provides a specific burden of proof. 123 It is unclear whether the IRS could successfully argue that section 1031(f)(2)(C) is a substantiation provision or has its own specific burden of proof, and thus is not subject to a shift of burden of proof to the IRS under section 7491(a).

VI. TAX PLANNING CONSIDERATIONS

Tax planning in the area of related-party exchanges often focuses on maintaining ownership of the retained and relinquished properties for two years, a time period that the IRS itself has recognized as a safe harbor. 124 If both the exchanger and related party defer dispositions of the exchanged property for more than two years, thereby avoiding section 1031(f) and achieving a related group basis swap under section 1031(a), they may be able to not only achieve the ability to apply the tax basis of the relatively high basis property to the first sale outside the group, but they can also use the benefit of the relatively higher basis to reduce income taxable at ordinary income rates rather than at capital gains rates. This can occur, for example, where the exchanger swaps property that was investment property in the hands of the exchanger at the time of the exchange but may become ordinary income property later.

122. 932 F.2d at 538-539.
123. See Clukey, Benefits of Shifting the Burden of Proof to the IRS are Limited, 82 TAX NOTES 683 (Feb. 1, 1999).
124. See FSA 200137003.
For example, suppose that in 1995 Teruya was an S corporation or partnership or individual, potentially eligible for capital gains rates, rather than a C corporation. Suppose further that Teruya directly exchanged Ocean Vista and Royal Towers and boot for Times’ KII, K, and KI in 1995, and that in 1998 Times converted Ocean Vista and Royal Towers to condominiums and sold all the condominiums.

Depending on the facts, Teruya could have recognized its $12.5 million appreciation in Ocean Vista and Royal Towers as ordinary income if Teruya itself did the condominium conversion in 1995. In contrast, if Teruya sold KII, K, and KI in 1998, Teruya’s gain, including the $12.5 million gain deferred from Ocean Vista and Royal Towers, could have been eligible for capital gains rates.

Where the two year holding period can be met, such a related party swap can also produce permanent corporate tax savings where the exchanger is a C corporation converting to S status. For example, if Teruya had converted to an S corporation in 1996 and sold KII, K, and KI after the 10-year built-in gain period expires, Teruya would permanently avoid corporate level tax on the $12.5 million 1995 appreciation in Ocean Vista and Royal Towers that became built-in gain of KII, K, and KI at the 1996 date of Teruya’s conversion to S status.

Where the two-year period cannot be satisfied because of the business necessity of a sale of one of the properties within two years, other strategies have been offered. These include avoiding the precise definitions of relatedness contained in sections 267(b) and 707(b) by utilizing related persons that do not come within the proscribed degree of relationship, such as an entity with fifty percent or less common ownership or, in the case of an individual, in-laws rather than blood relatives.

As mentioned above, the legislative history to section 453(e) makes it clear that the IRS is not precluded from utilizing the judicially created conduit rules to attack related party sales and resales that are outside the scope of section 453(e). The Senate Report on section 453(e) states that "[t]he 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." The IRS might likewise argue that section 1031(f) does not preclude conduit type attacks or the application of other judicially created

127. See supra Section II.A.
anti-abuse doctrines, such as substance over form. Nothing in the legislative history to section 1031(f) indicates that Congress intended to limit the anti-abuse resources available to the government in the administration of section 1031. For example, using conduit principles, such as was done in Rev. Rul. 77-414, the IRS might seek to tax the exchanger that exchanges property with a corporation in which the exchanger owns more than 10% but no more than 50% of the stock, pursuant to a plan where the corporation, which is in lower tax bracket, immediately resells the property to a third party for cash pursuant to an agreement negotiated with the exchanger.

VII. Conclusion

The Tax Court in Teruya Brothers accepted the IRS position that a exchanger is precluded from tax-deferral by section 1031(f)(4) with respect to exchange proceeds applied to acquire high basis property from a related party, even if the acquisition is made through a QI. However, because the fact pattern in Teruya Brothers was fairly simple, and the holding was for the IRS, the court failed to explore many of the open issues concerning the application of section 1031(f)(4).

The simplicity of that fact pattern may open the door for exchangers to seek to distinguish Teruya Brothers and argue for liberal interpretations of section 1031(f)(4). However, the fact that the Tax Court ruled for the IRS as a practical matter means that the Tax Court set no bounds on the potential scope of the application of section 1031(f)(4) by the IRS. Indeed, by grafting a "tax price" concept onto section 1031(f)(4), the Tax Court has increased the uncertainties inherent in that section. Until further guidance clarifies section 1031(f)(4), exchangers and their advisers must be cautious in structuring like-kind exchanges in situations where parties related to the exchanger will be involved.