OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Request for Field Service Advice

This Chief Counsel Advice responds to your memorandum dated February 9, 2001. In accordance with I.R.C. § 6110(k)(3) this Chief Counsel Advice should not be cited as precedent.

LEGEND

X =
Y =
A =
B =
Blackacre =
Whiteacre =
$u =
$v =
$w =
$x =
$y =
$z =
Year 1 =
Year 2 =
Year 4 =

ISSUES

1. Whether an exchange of property between X and Y qualifies for nonrecognition treatment under I.RC. § 1031.

2. Whether the subsequent disposition of the property by Y triggers gain to X under I.R.C. § 1031(f).

CONCLUSIONS

1. The exchange qualifies for nonrecognition treatment.

2. The subsequent disposition does not trigger gain to X.

FACTS

In Year 1, A formed X, a partnership. A owned 98% of X, and B, A's son, owned 2%. Before forming the partnership, A owned Blackacre. A contributed Blackacre to X along with other property in the vicinity of Blackacre.

Also in Year 1, B formed Y, an S corporation. On December 31 of Year 1, Y purchased Whiteacre for $u. The property was 100 percent financed, and the loan personally guaranteed by A. Y initially leased Whiteacre to an unrelated third party.

Blackacre and Whiteacre were like kind for purposes of I.R.C. § 1031.

In Year 2, X and Y exchanged Blackacre for Whiteacre. At the time of the exchange, Blackacre was worth $v and had a basis of $w. Whiteacre was worth $x and had an adjusted basis of $y.

X moved its business operations from Blackacre to Whiteacre and the parties systemically liquidated property they owned in the vicinity of Blackacre and Whiteacre. Over the next two years, virtually all the other property was sold, optioned, or donated to a charity, which was expanding its operations. In Year 4, a date more than two years after the exchange, X sold Whiteacre to the charity.

LAW AND ANALYSIS

I.R.C. § 1001 provides the general rule that gain or loss is realized on the sale or other disposition of property. Section 1031(a) provides an exception to this rule by providing that no gain or loss is recognized when a taxpayer exchanges property for property that is "like-kind." The basis of property acquired in a like-kind exchange is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer, and increased by the amount of gain or decreased by the amount of loss to the taxpayer recognized on the exchange.

I.R.C. § 1031(f)(1) provides that if a taxpayer exchanges property with a related person, resulting in the nonrecognition of gain or loss under section 1031 and, if within two years of such exchange the taxpayer or the related person disposes of the property received on the exchange, there is no nonrecognition of gain or loss on the exchange. Any gain or loss the taxpayer is required to recognize by reason of section 1031(f)(1) is taken into account as of the date of the disposition of the property.

I.R.C. § 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 term related person is defined under I.R.C. § 1031(f)(3) as any person bearing a relationship to the taxpayer described in section 267(b) or section 707(b)(1).

In this case, all the parties were related under the attribution rules. However, because the second disposition occurred more than two years after the exchange, I.R.C. § 1031(f)(1) does not literally apply. We believe that the two-year rule in section 1031(f)(1)(C) is a safe harbor that precludes application of section 1031(f)(1) to any transaction falling outside that period. Thus, a taxpayer acquiring property from a related party can avoid application of the rule in section 1031(f)(1) merely by waiting until after the two year period to dispose of the property.

Therefore, I.R.C. § 1031(f)(4) does not apply to this situation because there was no attempt by either party to circumvent the rules. Rather, the parties merely took advantage of what Congress allowed them by enacting the two-year rule. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Gregory v. Helvering, 293 U.S. 465, 469 (1935). In our view, the purpose of section 1031(f)(4) is to stop taxpayers from violating the two-year rule, and not to preclude taxpayers from planning to dispose of property after the two-year period. Thus, if a taxpayer exchanges property with a related party, intending to dispose of the replacement property after the two-year period, section 1031(f)(4) would not require recognition of the original gain. This analysis would not apply, however, if the exchange were a sham.

We believe that our view of I.R.C. § 1031(f)(4) is supported by the legislative history:

> Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated

> party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. (Emphasis added)

H.R. Rep. No. 247, 101st Cong.1st Sess. 1341 (1989). We think the key here is circumvention of the two-year rule, not a transfer with intent to dispose after the expiration of the two-year waiting period.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

One issue we see is a possible disparity in the value of the property. Under the facts presented, the exchange was roughly even: [redacted] exchanged property worth [redacted] subject to a [redacted] mortgage for property [redacted]. If, however, the original [redacted] property was worth more than the [redacted] property, [redacted] may have taken capital out the corporation and contributed it to the partnership, resulting in a constructive dividend to [redacted] and a gift to [redacted]. Similarly, if the reverse were true, [redacted] may have received a distribution from [redacted] and made a gift to [redacted]. [redacted]

Please call if you have any further questions.

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