INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 22, 2001

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CASE MIS No.: TAM-107507-00/CC:ITA:B5

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No:
Years Involved:
Date of Conference: June 26, 2000

LEGEND:

m =

n =

Condominium Association =

Intermediary = .

Lessee =

Property 1 =

Property 2 =

Property 3 =

Property 4 =

Property 5 =

Purchaser =
(individually or
collectively)

Related Party=

Taxpayer =

ISSUE:

Whether two 1995 multi-party exchange transactions to which the Taxpayer was party will be denied §1031 nonrecognition treatment as exchanges which were part of a transaction (or series of transactions) structured to avoid the purposes of §1031(f).

CONCLUSION:

Each of the Taxpayer's 1995 multi-party exchange transactions was part of a transaction (series of transactions) structured to avoid the purposes of §1031(f). Accordingly, §1031(a) nonrecognition treatment is denied each of the exchanges.

FACTS:

In the taxable year involved, the Taxpayer owned investments in real property and operated a number of different businesses. The Related Party operated a retail business through a number of stores. It developed and/or owned some of the real property on which its stores were located.

The Taxpayer owned m percent of the stock of Related Party. Members of two families that owned the stock of the Taxpayer owned n percent of the stock of the Related Party. Taxpayer and the Related Party were related parties within the meaning of §267(b) and §1031(f)(3).

Exchange 1:

The Taxpayer owned a fee simple in a high-rise residential rental property, Property 1. Based on its belief that there was an oversupply of residential units that would persist over the long-term, the Taxpayer decided to dispose of Property 1.

To avoid current recognition of taxable gain on the disposition, the Taxpayer intended to structure the disposition as a like-kind exchange. Consistent with that objective, the Taxpayer executed a Letter of Intent for the purchase of two properties, Property 2 and Property 3, from the Related Party at mutually agreeable prices, subject to a "1031 four party exchange." The Taxpayer's basis in Property 1 was less than 10 percent of the amount realized from the sale of the property.

The Related Party had acquired a parcel of land for development in 1992. It subdivided the parcel into one large parcel (Property 2) and two small parcels for commercial use (Property 5). The small parcels were leased, or held for lease, to others. A shopping center, which included one of Related Party's stores, was developed on Property 2.

To finance the development of Property 2, the Related Party negotiated a borrowing agreement with its bank. The agreement, secured by the Related Party's real properties, allowed Related Party to borrow up to a specified maximum amount.

During the period subsequent to 1992, the Related Party's business experienced heightened competition from well-capitalized local and national retailers. During the period, Related Party closed two of its stores.

In 1994, at a time when its borrowing agreement with its bank was approaching its upper limit, Related Party negotiated a 20 percent increase in the maximum level of funds available to it under the agreement.

The information provided included a statement that the Related Party was having trouble servicing its debt. That information also indicated that approximately 50 percent of the total principal amount of its bank debt was due in August 1995; 27 percent in January 1996; and the balance in November 2002.

Based on concerns about the slowing economy, increased competition, and the continued growth of its bank debt, Related Party decided to sell Property 2.

The owner of Property 2 had the right to restrict the amount of retail business of a specified type that could be conducted on an adjoining property that competes with the shopping center on Property 2 and specifically with Related Party's store on Property 2. As majority shareholder of Related Party, the Taxpayer indicated that it had an economic interest in acquiring Property 2 in order to control the amount of competition for the Related Party's store.

Property 3 was adjacent to another property on which the Related Party had a store. The two properties shared a parking lot. In the past, the arrangement for parking had been a source of difficulty between the ground lessee of Property 3 and the Related Party. The Taxpayer, as majority shareholder of Related Party, had an interest in acquiring Property 3 since the long-term plan for that property could significantly impact the operations of Related Party's store on the adjacent property.

On September 6, 1994, before the Taxpayer listed Property 1 for sale, it executed a letter of intent to purchase Property 2 and Property 3 from the Related Party. The Related Party intended to use the sales proceeds to pay down its debt. The letter provided that the sale was subject to "a 1031 four-party exchange." The Taxpayer had a low basis in Property 1 and wanted to avoid gain recognition by use of a like-kind exchange.

On December 12, 1994, the Taxpayer signed a contract to sell Property 1 to the Purchaser. Purchaser contemplated conversion of the property to a condominium and sale of the units in “as is” condition. The sales contract stated that the Taxpayer intended to transfer Property 1 by means of a “deferred exchange under section 1031.” The contract provided that the closing on Property 1 would be simultaneous with the closing of the exchange transaction. Closing was to take place between March 1, 1995 and July 31, 1995.

As evidence of a weakening residential rental market which prompted its interest in selling Property 1, the Taxpayer noted that the occupancy rate of Property 1 dropped progressively from 91 percent in September 1994 to 83 percent in October,1994; 81 percent in January, 1995; 76 percent in February 1995, and 72 percent in March 1995. The information did not indicate whether the trend in the occupancy rates was representative of the occupancy rates for comparable rental properties in the area in which Property 1 was located. It also did not indicate whether the occupancy rate was significantly impacted by the required notice to tenants 120 days in advance of the end of their leases of the intended conversion of the property to a condominium. The information provided indicated that the purchaser intended to convert the property to condominium ownership in “as is” condition.

The Purchaser’s obligations under the contract were contingent upon a due diligence period, its ability to obtain financing for 100 percent of the purchase price within a specified period, and receipt of satisfactory reports from various building engineers.

As a result of Purchaser’s inability to obtain financing within the specified period and a weaker than anticipated response from the condo conversion notices, the Taxpayer and Purchaser amended the sales contract to reflect a price reduction. The price reduction was for an amount that represented approximately 12 percent of the sales price in the initial contract. The contract, as amended, was also subject to Purchaser obtaining financing of 100 percent of the purchase price on specified terms within a specified period. On April 27, 1995, the Taxpayer’s Board of Directors approved the sale of Property 1 for the sales price indicated in the amended sales contract.

In a July 5, 1995, letter to the Purchaser, a lender indicated that it was willing to consider financing Purchaser’s acquisition of Property 1 if the Taxpayer would provide a limited guaranty of approximately 20 percent of the principal amount of the loan. The principal amount of the loan was to be for an amount $400,000 in excess of the sales price, as amended, of Property 1.

On July 14, 1995, the Taxpayer and Purchaser extended the closing date to August 17, 1995.

On August 2, 1995, the Taxpayer entered into an exchange agreement with Intermediary. The contract for the sale of Property 1 was assigned to the Intermediary.

On August 22, 1995, Taxpayer, Purchaser, and the lender executed a limited guaranty whereby Taxpayer guaranteed payment of a portion of the financing to be provided to Purchaser.

Although the closing on Property 1 did not take place when on August 17, 1995, when scheduled, the closing date was not formally extended. The closing took place on August 24, 1995, the same date as the closings on the Related Party's sales of Property 2 and Property 3 to the Intermediary for transfer to the Taxpayer as replacement properties.

The Taxpayer did not recognize the gain realized on the sale of Property 1. The Related Party reported the gain realized on the sale of Property 3. The loss sustained on the sale of Property 2 was deferred in accordance with the provisions of §267(f).

<u>Exchange 2</u>:

The Taxpayer owned the fee in a parcel of land that was subject to a long-term ground lease to Lessee (Property 4). The Lessee's leasehold interest was subject to a sublease to the Condominium Association of the condominium constructed on the land. On March 22, 1993, the Board of Directors of the Condominium Association contacted the Taxpayer concerning the potential conversion of the Condominium Association's leasehold interest to a fee.

The Taxpayer advised the Board of Directors of the Condominium Association that it would only negotiate with the Lessee and not the Condominium Association or its members. After a period of negotiation, the Taxpayer and the Lessee reached an agreement which provided for sale of the Taxpayer's fee to the Lessee. The agreement was contingent upon the Lessee obtaining a binding commitment from the Condominium Association to purchase the interest on terms acceptable to the Lessee. The agreement was also contingent upon the Condominium Association having a firm financing commitment in place. The sales price, which was determined as if the fee were not encumbered by the ground lease, approximated the assessed value of the fee for 1993-94 real estate taxes. The agreement was subsequently amended to provide that the Taxpayer's obligation to sell its interest in the fee to the Lessee was conditioned upon the Taxpayer consummating a section 1031 exchange.

In an April 29, 1993, letter of intent addressed to the Taxpayer, Lessee offered to purchase Property 4. In that letter, Lessee offered to cooperate with the Taxpayer so that the Taxpayer could "effectuate a 1031 tax deferred exchange." The Taxpayer had a low basis in Property 4 and wanted to avoid gain recognition by use of a like-kind exchange.

The deadline for the Condominium Association's provision to the Lessee of a binding commitment to purchase the fee which the Lessee was to acquire from the Taxpayer was repeatedly extended from October 31, 1993, to January 31, 1994; to April 31, 1994; and June 30, 1994. Similarly, the original closing date of March 31, 1994 was extended to June 30, 1994; to September 30, 1994; and December 15, 1994. Although the material does not provide specific reasons for each of the extensions, it includes a general statement to the effect that the extensions were the result of the contract conditions not being satisfied.

On June 14, 1994, the Taxpayer, the Lessee, and the Condominium Association executed an Assignment, Assumption, and Release Agreement substituting the Condominium Association for the Lessee so that the Taxpayer and the Condominium Association could negotiate and consummate any sale directly between each other. Under the terms of the agreement, the Condominium Association could cancel the proposed purchase if, by June 30, 1994, it had not obtained an executed sale agreement acceptable to both parties, a firm financing commitment to purchase the Taxpayer's interest, and a binding commitment from a specified percentage of condominium unit owners to purchase the leased fee interest in the land from the Condominium Association.

Despite the fact that the conditions specified in the Assignment, Assumption, and Release Agreement were not fulfilled by the June 30, 1994 deadline and the absence of an extension of that deadline or the December 15, 1994, closing date, a sales contract was signed on April 3, 1995. The Taxpayer's Board of Directors approved the sale on April 27, 1995. The contract contained conditions similar to those included in the Assignment, Assumption, and Release Agreement and specified September 1, 1995 as the closing date. The closing date was subsequently extended to September 15, 1995, to allow the Condominium Association time to satisfy the conditions of the contract.
The additional time was not needed.

On July 27, 1995, the Taxpayer's Board of Directors approved the sale of Property 4 and Related Party's Board of Directors approved the sale of Property 5.

The closing on the sale of Property 4 to the Condominium Association and the Intermediary's application of the sales proceeds and additional funds provided by the Taxpayer to purchase Property 5 from Related Party took place on September 1, 1995.

The Taxpayer represents that it always intended to have a deferred exchange and that a direct exchange was never considered. The Taxpayer had previously engaged in §1031(a) exchanges in 1987 and 1988.

APPLICABLE LAW:

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

Section 1031(d) provides that the basis of property acquired in a like-kind exchange is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange.

Section 1.1031(k)-1(g) of the regulations establishes various safe harbors for deferred exchanges which provide that a taxpayer is not in actual or constructive receipt of money or other property (not of like-kind) for purposes of §1031(a). One of the safe harbors listed in paragraph (g) is that for a "qualified intermediary."

Section 1.1031(k)-1(g)(4)(iii) of the regulations defines a qualified intermediary as a person who (A) is not the taxpayer or a disqualified person and (B) enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(b)-2(a) of the regulations provides that in the case of simultaneous transfers of like-kind properties involving qualified intermediaries (as defined in §1.1031(k)-1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of §1031(a). In such a case, the transfer and receipt of property by the taxpayer is treated as an exchange.

Section 1031(f) (1) provides that if a taxpayer exchanges property with a related person, resulting in nonrecognition of gain or loss under this section with respect to the exchange (determined without regard to this subsection), and within two years of the date of the last transfer which was part of such exchange the related person or the taxpayer disposes of the property received in the exchange, there shall be no nonrecognition of gain or loss under §1031. Any gain or loss required to be recognized by the taxpayer by reason of §1031(f)(1) shall be taken into account as of the date such latter disposition occurs.

Section 1031(f)(2) provides that for purposes of paragraph (f)(1), there shall not be taken into account any disposition (A) after the earlier of the death of the taxpayer or the death of the related person, (B) in a compulsory or involuntary conversion (within the meaning of §1033a) if the exchange occurred before the threat or imminence of such conversion, or (C) with respect to which it is established to the satisfaction of the

Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax.

Section 1031(f)(3) provides that the term “related person” means any person bearing a relationship to the taxpayer described in §267(b) or §707(b)(1).

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

Section 267(a) provides that no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b).

Section 267(b)(3) includes two corporations which are members of the same controlled group (as defined in subsection (f)) as a relationship referred to §267(a).

Section 267(f)(1) provides that for purposes of §267, the term “controlled group” has the meaning given to such term by §1563(a), except that (A) “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears in §1563(a), and (B) the determination shall be made without regard to subsections (a)(4)(certain insurance companies) and (e)(3)(C)(stock owned by certain employees’ trusts described in §401) of §1563.

Section 267(f)(2) provides that in the case of any loss from the sale or exchange of property between members of the same controlled group and to which subsection (a)(1) applies, subsection (a)(1) and (d) shall not apply to such loss, but such loss shall be deferred until the property is transferred outside such controlled group and there would be recognition of loss under consolidated return principles or until such other time as may be prescribed by regulations.

ANALYSIS:

Examination proposed denial of nonrecognition treatment for the Taxpayer’s multi-party exchanges based on the application of §1031(f)(4). The multi-party exchanges facilitated the shifting of the Taxpayer’s low basis in its relinquished property (Property 1 and Property 4) to the replacement property (Properties 2, 3, and 5) which had been owned by the Related Party prior to the transactions that included the exchanges. The transactions facilitated the Taxpayer/Related Party controlled group’s reduction in its investment in real property and application of amounts realized from the sale of the Taxpayer’s relinquished property to reduction of the Related Party’s bank debt. The consequences of the transactions were those to which §1031(f) is specifically addressed, i.e., basis shifting and “cashing out” of investments through transactions (series of transactions) which involve an exchange and related parties.

For the reasons set forth below, we agree with Examination's determination.

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. See H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1340 (1989).

H. R. Rep. No. 101-247, 101st Cong., 1st Sess. 1340 (1989) indicates that the committee was aware that related parties engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on a subsequent sale of the low basis property. The committee also took note of the fact that the installment sale provisions addressed taxpayers' use of related party installment sales of low basis property to avoid current recognition of income on a second disposition of the property to an unrelated party.

Section 453(e) provides, in general, if any person disposes of property to a related person (the first disposition) and within two years of the first disposition and before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (the second disposition), the amount realized on the second disposition shall be treated as received at the time of the second disposition by the person making the first disposition. The effect of §453(e) is to treat the taxpayer and related party as if they were a single economic unit. If the amount of the payments received with respect to the second disposition is in excess of the amount of the payments taken into account with respect to the first disposition, the excess is treated as if it were a payment with respect to the first disposition. The gain inherent in such excess is required to be recognized as the economic unit has "cashed out" that portion of its investment in the property which was sold. Continued availability of the installment method for the related party sale would facilitate tax avoidance, i.e., the taxpayer would defer the tax on the related party installment sale while a second disposition for cash would result in no gain. Absent §453(e), the taxpayer could structure the installment sale so no principal payments would be due and no income recognized until some distant future date. The time value of the investment return on the tax savings could fund the eventual tax payment.

Section 1031(f)(1) is patterned on §453(e). The committee believed a related party exchange, which was followed shortly thereafter by a disposition of the property received in the exchange should not be accorded nonrecognition treatment. H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1340 (1989). Denial of nonrecognition treatment for the exchange involved in such transactions would eliminate the potential for basis shifting which facilitated nonrecognition of gain on the subsequent disposition of the property received in the exchange.

Section 1031(f)(2) provides that certain dispositions will not be taken into account for purposes of §1031(f)(1)(C). The excepted dispositions include (A) a disposition after the earlier of the death of the taxpayer or the death of the related person, (b) a compulsory or involuntary conversion (within the meaning of §1033) if the exchange occurred before the threat or imminence of such conversion, or (C) a 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. House Conf. Rep. No. 101-386. 101st Cong., 1st Sess. 614 (1989) indicates that the Senate amendment was the same as the House bill, except that the non-tax avoidance exception generally would apply to (1) a transaction involving certain exchanges of undivided interests, (2) dispositions in nonrecognition transactions, and (3) transactions that do not involve the shifting of basis between properties.

The Taxpayer advanced a number of arguments in support of the position that its two exchange transactions are entitled to nonrecognition treatment under §1031(a).
First Argument:

The application of §1031(f)(4) is limited to circumstances in which an exchange described in §1031(f)(1)(A) and (B) and a §1031(f)(1)(C) disposition would have been feasible. The Taxpayer maintains that direct exchanges-subsequent sales similar to those described in H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1340 (1989) were not feasible in its circumstances and, consequently, it and Related Party were not the kind of related parties to whom the related party rules were intended to apply.

The position advocated by the Taxpayer would interpret §1031(f)(4) as if it only applied to transactions structured to avoid a direct related party exchange and then only if such transactions would have been feasible in circumstances which were the result of the Taxpayer's actions and planning. By its express terms, §1031(f)(4) denies nonrecognition treatment to any exchange that is part of a transaction (series of transactions) structured to avoid the purposes of §1031(f). The focus of §1031(f)(4) is avoidance of the purposes of §1031(f) rather than avoidance of a specific type of transaction. The purpose of §1031(f)(4), as indicated in the legislative history, is to deny nonrecognition treatment to any exchange (other than the direct exchanges specifically addressed in §1031(f)(2)) that is part of a transaction (series of transactions) which involves related parties and is structured to avoid the purposes of §1031(f), e.g., denial of nonrecognition treatment for any exchange that is part of a transaction (series of transactions) that involve basis shifting, "cashing out" of an investment, reduction or avoidance of gain, or acceleration of losses. By its express terms, §1031(f)(4) denies §1031 nonrecognition treatment to any exchange which is part of a transaction structured to avoid the purposes of §1031(f); the exchange need not be a direct related party exchange. Consequently, a position that §1031(f)(4) only applies in circumstances where a direct related party exchange-subsequent sale would have been feasible would unwarrantedly restrict the application of §1031(f)(4) on the basis of circumstances that have little, if any, relationship to the purposes of that section. There is no authority for such a position.

Even though the feasibility of a direct related party exchange-subsequent sale is not a criterion for application of §1031(f)(4), the information provided would not support a conclusion that such transactions were not feasible in the circumstances. Although the terms and conditions of a direct exchange may have differed from those agreed upon in anticipation of a deferred exchange, a direct exchange was possible.

The Taxpayer asserts that deteriorating real estate market conditions and various contingencies or escape clauses in the letters of intent and sales contracts for the relinquished properties increased the risks associated with the transactions. Unrelated purchasers of the properties might attempt to negotiate price reductions or withdraw from the purchase of the relinquished properties from the Related Party after a direct exchange. A direct exchange would have been perceived as an attempt to shift those perceived risks to the Related Party and its bank, which was also the Taxpayer's bank. The transactions would have adversely affected both the Taxpayer's and Related Party's banking relationships as well as the Related Party's relationship with its minority shareholders. The members of the Taxpayer's Board of Directors who were also members of the Related Party's Board of Directors may have been subject to conflict of interest charges if the transactions produced disappointing results. Based on these considerations, the Taxpayer argues that it and the Related Party were precluded from acting as related parties and a single taxpayer. For those same reasons, the Taxpayer stated that a direct exchange-subsequent sale was not even considered a possibility. Had any such plan been suggested, it would have been rejected.

The fact the sale of each of the Taxpayer's relinquished properties was interdependent with and conditioned upon the Taxpayer consummating a like-kind exchange and the simultaneous closings on sale and exchange transactions (series of transactions) belies the Taxpayer's position. The Taxpayer described each of the contractual agreements between the parties as a mutually interdependent part of an integrated plan; each transaction was contingent upon the successful completion of the other transactions. Direct exchanges-subsequent sales also could have been structured as mutually interdependent transactions with simultaneous closings. If additional assurance of performance by the unrelated purchasers of the relinquished properties had been desired, the Related Party could have required the unrelated purchasers to provide such assurance.

The direct related party exchanges-simultaneous dispositions need not have resulted in constructive receipt of the sales proceeds by the Taxpayer. The Related Party could have been the seller of the Taxpayer's relinquished properties which it received in the direct exchange. The Related Party's sales could have been interdependent with and conditioned upon the direct exchange in the same manner that the Taxpayer's transfer of its relinquished properties to the Intermediary and the Intermediary sales of those properties were conditioned upon the Taxpayer's ability to consummate a like-kind exchange. The Taxpayer could have had no right to sales proceeds so there would have been no issue concerning constructive receipt with respect to the Taxpayer.

The information submitted does not provide any support for the Taxpayer's statement that direct related party sales-subsequent dispositions would have adversely affected the relationship of either the Taxpayer or the Related Party with its bank(s). There is no evidence that the bank(s) had any input concerning the structure of the transactions.

Mutually interdependent direct related party exchanges-subsequent sales could have precluded shifting of risk from the Taxpayer to the Related Party and need not have adversely affected the Related Party's relationship with its minority shareholders. The agreement could have provided that the exchanges would be conditioned upon the sales and would not take place if the sales did not occur; there would have been no risk shifting to the Related Party or its minority shareholders. Although the Taxpayer states that direct exchanges-subsequent sales would have presented additional risk because of the declining real estate market, the information provided does not establish a basis for a position that mutually interdependent direct exchanges-subsequent sales, similar to those described above, could not have been structured within the considerable period between initiation of negotiations and closing of the transactions that actually took place.

Although the Taxpayer stated that direct related party exchanges-subsequent sales would have exposed individuals who were members of the boards of both the Taxpayer and the Related Party to potential conflict of interest charges, such transactions would not appear to have presented any greater potential for such allegations than that posed by the actual transactions. For the reasons indicated above, mutually interdependent direct related party exchanges-subsequent sales need not have shifted risk to the Related Party or its minority shareholders. The information provided indicates that the properties involved in the transactions were subject to independent appraisals and that the transactions took account of the fair market value of the properties.

There is no reason to contest the Taxpayer's statement that direct exchanges-subsequent sales were not even considered by the parties. The Taxpayer is sophisticated in tax matters and had been involved in prior like-kind exchanges. Given this knowledge, it is almost certain that the Taxpayer knew that direct exchanges-subsequent dispositions would have resulted in denial of nonrecognition treatment. The Related Party would have been denied nonrecognition treatment on the exchanges because the properties received in the exchange would have been sold rather than held for use in a trade or business or for investment. The Taxpayer would have been denied nonrecognition treatment for the exchanges by reason of §1031(f)(1).

The Taxpayer also knew that the objective of avoiding current tax on the disposition of Property 1 and Property 4 was dependent upon avoiding the application of §1031(f). That knowledge and prior experience with like-kind exchanges, provides support for a position that the subject transactions were structured to avoid the purposes of §1031(f). Such a position would be consistent with the Taxpayer's attribution of the structure of the subject transactions to tax planning and the description of each of the contractual agreements between the parties as a mutually interdependent part of an integrated plan; each transaction was contingent upon the successful completion of the other transactions. There is no indication that the Taxpayer ever contemplated acquisition of replacement property other than the property of the Related Party; it executed a letter of intent for the purchase of some of the properties before negotiating the sale of its relinquished property.

The Taxpayer did not cite any authority in support of its position that criteria other than the relationship of the parties involved are relevant to application of a provision, such as §1031(f), that provides specific treatment for related parties. Section 1031(f)(3) provides a definition of the term “related party” for purposes of §1031(f).

Section 1031(f)(3) provides that for purposes of §1031(f) the term “related person” means any person bearing a relationship to the taxpayer described in §267(b) or 707(b)(1). Even if the Taxpayer had demonstrated circumstances that precluded it and the Related Party from acting as related parties, there is no authority that would support an exception from the related party provisions. The application of the related party rules is not dependent upon parties acting as related parties; §267 denies deduction of a loss sustained on a related party sale regardless of the fact that the terms of sale were arms length. Congress imposed an absolute prohibition against deduction of losses on sale of property to a related party because the property remained in the related group after the sale, irrespective of whether the sale was bona fide, voluntary or involuntary, or direct or indirect. H.R. 704, 73d Cong., 2d Sess. 23 (1934), 1939-1 C.B. Part 2) 554; S. Rept. 558 73d Cong., 2d Sess. 27 (1934), 1939-1 C.B. Part 2) 586. In order to implement Congressional intent for an absolute prohibition of deduction of losses on related party sales, it is essential that no exceptions from the §267 attribution rules be allowed. The fact that §1031(f) provides for application of the attribution rules of §267 and that §1031(f)(2) provides specific exceptions from the treatment indicated by §1031(f)(1) for direct related party sales- subsequent exchanges evidences Congressional intent that the exceptions be limited to those provided for in §1031(f)(2).

Under the Taxpayer’s view, application of §1031(f)(4) would require a preliminary determination whether a direct exchange-subsequent sale would have been feasible in the circumstances that existed at the time the transactions took place. Circumstances that to a significant extent were created by the Taxpayer’s planning. There is no authority for such a position. Such an interpretation would allow related parties to easily avoid the application of §1031(f)(4) by using an agreement that solely provided for a deferred exchange. It would restrict the application of §1031(f)(4) on the basis of an irrelevant criterion.

<u>Second Argument</u>:

The Taxpayer’s multi-party exchanges are not subject to §1031(f) since the application of that section is limited to circumstances that involve a direct or indirect related party exchange. The Taxpayer's exchange transactions involve related party sales of replacement property for its exchange transactions with the Intermediary. Section 1031(f) does not apply in the absence of a direct or indirect related party exchange.

The Taxpayer believes the Senate Finance Committee Report's inclusion of an example which involves an indirect related party exchange is indicative that the application of §1031(f) is limited to circumstances that involve a direct or indirect related party exchange. It maintains §1031(f) has no application to its multiparty exchanges because those transactions involved related party sales, i.e., the Related Party's sales of Property 2, Property 3, and Property 5 to the Taxpayer as replacement property for its exchange transactions with the Intermediary, rather than direct or indirect related party exchanges.

The focus of §1031(f)(4) is <u>any</u> exchange which is part of a transaction (series of transactions) structured to avoid the purposes of §1031(f) rather than transactions structured to avoid a transaction or a specific type of transaction. The purpose of section 1031(f)(4), as indicated in the legislative history, is to deny nonrecognition treatment to <u>any</u> exchange (other than the direct exchanges specifically addressed in §1031(f)(2)) that is part of a transaction (series of transactions) which involves related parties and is structured to avoid the purposes of §1031(f), e.g., denial of nonrecognition treatment for any exchange that is part of a transaction (series of transactions) that involve basis shifting, "cashing out" of an investment, reduction or avoidance of gain, or acceleration of losses. By its express terms, §1031(f)(4) denies §1031 nonrecognition treatment to <u>any</u> exchange which is part of a transaction structured to avoid the purposes of §1031(f); the exchange need not be a direct related party exchange. The example in the Senate Finance Committee Report is indicative that reordering the sequence of transactions will not place the transactions beyond the scope of §1031(f)(4).

If the application of §1031(f) were limited to circumstances which involved a direct related party exchange, the provision would be meaningless since its application could be so easily circumvented by using an intermediary. The use of an intermediary to avoid tax on a disposition of a taxpayer's relinquished low basis property to an unrelated party and the intermediary's application of the sales proceeds to purchase replacement property from a related party facilitates avoidance of the purposes of §1031(f). Accordingly, §1031(f)(4) denies nonrecognition to any exchange involved in such transactions.

<u>Third Argument</u>:

The use of the Intermediary in the Taxpayer's multiparty exchange transactions was required to avoid the Taxpayer having constructive receipt of the sales proceeds from the relinquished properties. Section 1.1031(b)-2(a) of the Income Tax Regulations provides that a qualified intermediary is not considered the agent of the taxpayer for purposes of §1031(a). Based on recognition of a qualified intermediary as a participant in an exchange transaction rather than an agent of a participant and the Intermediary's purchase of replacement properties from the Related Party, the Taxpayer's transactions involved related party sales rather than related party exchanges subject to §1031(f).

Structuring of a transaction which involves an exchange to justify the use of a qualified intermediary will not place the transaction beyond the scope of §1031(f)(4) if the transaction facilitate avoidance of the purposes of §1031(f), basis shifting (or identical consequences) between related parties; tax free or tax deferred cashing out of an investment by a taxpayer or a related party; reduction or avoidance of tax; acceleration of losses; etc. In such circumstances §1031(f)(4) will apply to deny nonrecognition with respect to the exchange transaction. The safe harbor provisions of §1.1031(b)(2) concerning qualified intermediaries will not cause a transaction (series of transactions) that is structured to avoid the purposes of §1031(f) to be beyond the scope of §1031(f)(4). Section 1.1031(b)-2(a) specifically provides that the qualified intermediary will not be considered the agent of the taxpayer for purposes of section 1031(a); the characterization does not apply for purposes of §1031(f).

<u>Fourth Argument</u>:

The Taxpayer's multiparty exchange transactions are not subject to §1031(f)(4). Section 1031(f)(2)(C) provides that the disposition of property received in a direct related party exchange will not be taken into account for purposes of §1031(f)(1)(C) if neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax. Accordingly, one of the purposes of §1031(f) is to disregard any disposition that does not involve tax avoidance. A disposition not taken into account for purposes of §1031(f)(1)(C) by reason of §1031(f)(2)(C) does not avoid the purposes of §1031(f); §1031(f)(4) is not applicable to such a disposition since it does not avoid the purposes of §1031(f). Section 1031(f)(2)(C)'s preservation of nonrecognition treatment for an exchange in circumstances which involve an excepted disposition is indicative that the phrase "avoidance of Federal income tax" does not encompass tax deferral pursuant to §1031. The Taxpayer's multiparty exchanges, which provide tax deferral pursuant to §1031, are not subject to §1031(f)(4).

The argument does not consider the requirement of §1031(f)(2)(C) that a taxpayer must satisfy the Service that tax avoidance was not a principal purpose of both an exchange and disposition in order for a disposition not to be taken into account for purposes of §1031(f)(1)(C) by reason of §1031(f)(2)(C). If circumstances warranted a conclusion that tax avoidance was one of the principal purposes for an exchange, a disposition would not be excepted by §1031(f)(2)(C) from treatment as such for purposes of §1031(f)(1)(C).

Sections 1031(f)(1) and (2) address the consequences of a direct related party exchange and a subsequent sale of the property received in the exchange. The Taxpayer's multiparty exchanges are not within the scope of §1031(f)(1). However, even if the tax avoidance standard of §1031(f)(2)(C) were applied to the Taxpayer's multiparty transactions, the conclusion would be that the Taxpayer has not established that tax avoidance was not one of the principal purposes of the exchange and/or the disposition of the Taxpayer's relinquished property.

The use of a qualified intermediary in circumstances involving the sale of a taxpayer's relinquished property and the intermediary's application of the sales proceeds to purchase replacement property from a related party will, generally, be treated as facilitating "cashing out" of an investment. The legislative history of §1031(f)(4) indicates that denial of nonrecognition treatment for an exchange that facilitates "cashing out" of an investment was one of the purposes for the enactment of the provision. The Taxpayer's transactions were structured to alter the sequence of the transactions in an attempt to avoid the application of §1031(f)(4). The example in the Senate Finance Committee Report indicates that such actions will not preclude the application of §1031(f)(4)..

Fifth Argument:

Section 1031(f)(4) must distinguish between cases, such as Taxpayer's, that are the result of tax planning and those that are the result of abusive tax avoidance, i.e., cases that would not qualify as §1031(f)(2)(C) exceptions. Section 1031(f)(4) has no application to the Taxpayer's exchange transactions because they were the result of tax planning.

An argument that the Taxpayer's transactions are the result of tax planning provides basis for application of §1031(f)(4) to deny nonrecognition for Taxpayer's exchanges as part of a transaction (or series of transactions) structured to avoid the purposes of §1031(f). The structure of the subject transactions, their intended results, i.e., basis shifting, cashing out an investment, the interdependence of each of the transactions on each of the other transactions, and the Taxpayer's statement that the transactions were the result of tax planning, compel a conclusion that the transactions were structured to avoid the purposes of §1031(f). The structure of the transactions was driven by the intent of the Taxpayer and the Related Party to "cash out" of some of the Taxpayer's investment in appreciated property with a low basis without current tax consequence in a manner that would provide funds for reduction of the Related Party's debt without the necessity of an additional capital contribution by, or loan from, the Taxpayer. Denial of nonrecognition treatment for an exchange that is part of transactions structured for such purposes is consistent with the intent of §1031(f)(4).

If tax planning were a basis for exception from anti-abuse provisions such as §1031(f), the provisions would have no impact as many tax abusive transactions evidence significant and ingenious planning.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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