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TAX INSTITUTE

STRUCTURING CONSIDERATIONS FOR SECTION 1031 EXCHANGES

By

Todd D. Keator
Deloitte Tax LLP
Dallas, TX

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SESSION I

Todd D. Keator
Principal
Deloitte Tax LLP
tkeator@deloitte.com

Todd Keator is a principal in Deloitte Tax LLP and leader of the Washington National Tax Sec. 1031 exchange practice. With over two decades serving clients in a variety of U.S.-side transactional tax matters, Keator brings strong experience advising individuals, partnerships and large corporations in various Sec. 1031 exchange transactions, with a focus on the real estate and energy sectors.

Prior to joining Deloitte, Keator co-led the Tax, Executive Compensation and Employee Benefits Practice at Holland & Knight. His responsibilities included representing clients in a variety of U.S. transactional tax matters, with a focus on the real estate and oil and gas sectors. Representative experience included partnership and LLC formation, operation, structuring and transactions; merger and acquisition (M&A) transactions, including negotiation of tax provisions in a variety of purchase and sale agreements; real estate transactions, including tenancy-in-common structures, syndications, joint ventures, development deals and capital gain planning, and FIRPTA advice; guidance for tax-deferred Sec. 1031 exchanges and involuntary conversions under Sec. 1033; dealer v. investor structuring and analysis, including Bramblett transactions; oil and gas syndications, joint ventures, and transactions; and private equity fund and portfolio company formation, operations, restructuring, and M&A deals.

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STRUCTURING CONSIDERATIONS FOR 1031 EXCHANGES

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1. Federally Declared Disasters

a. Rev. Proc. 2018-58 can extend the 45-day and 180-day deadlines in 1031 exchanges in the event of a federally declared disaster.

b. IRS generally will issue a Notice identifying the "federally declared disaster" area and "affected taxpayers" who may utilize the relief.

c. Typical disasters: hurricanes, tornados, fires, severe storms, floods.

d. Disaster area typically is listed by county; list may be updated

e. Recent examples:

(i) North Carolina – Hurricane Helene (September 25, 2024). Sec. 6 extended deadline is September 25, 2025.

(ii) California – LA Wildfires (January 7, 2025). Sec. 6 extended deadline is October 15, 2025.

(iii) Texas – Hill Country Flooding (July 2, 2025). Sec. 6 extended deadline is February 2, 2026.

f. Extension relief applies to:

(i) An Affected Taxpayer – a person or entity with a residence or principal place of business in the disaster area. Can choose between "Sec. 6" and "Sec. 17" relief.

(ii) A Non-Affected Taxpayer who has "difficulty meeting" the exchange deadlines for certain specified reasons, including that the relinquished property or replacement property was located in the covered disaster area. Limited to Sec. 17 relief only.

g. Sec. 6 relief

(iii) Extends 45-day and 180-day deadlines falling after the date of the disaster to the applicable date stated in the Notice.

(iv) Applies to 1031 exchanges started before <u>or after</u> the date of the disaster.

h. Sec. 17 relief

(v) Extends 45-day and 180-day deadlines falling after the date of the disaster to the longer of the applicable date stated in the Notice, or the regular deadlines + 120 days.

(vi) Applies only to 1031 exchanges started *before* the date of the disaster.

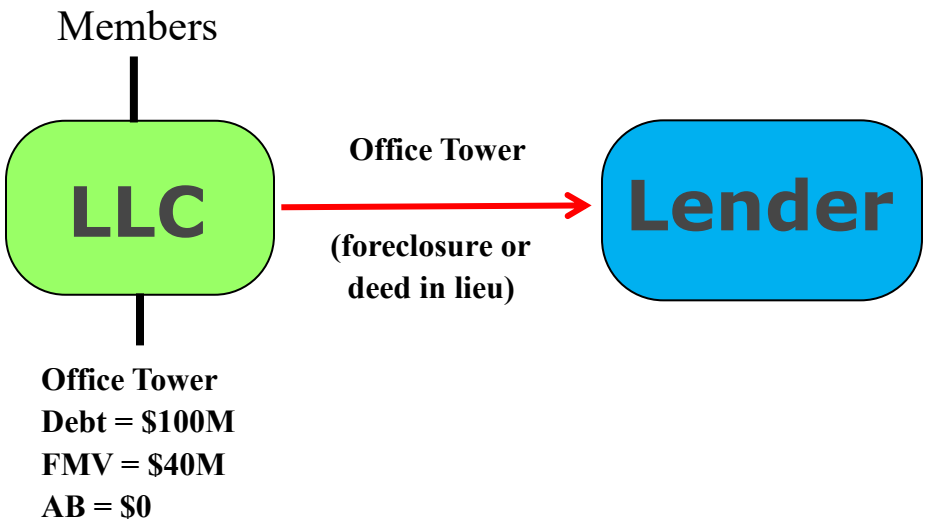
(vii) If the 45-day ID period has already passed prior to the disaster date, the 45 days may not be extended unless the identified property was substantially damaged by the disaster, in which case the 45 days may be retroactively extended.

i. QI Issues

(viii) Most Exchange Agreements require TP to notify QI if TP intends to apply disaster relief to extend deadlines.

(ix) May also require amending Exchange Agreement to provide for extended deadlines.

2. Section 1031 Exchanges Out of Foreclosure



a. Without any further planning, the transfer will generate phantom (cashless) gain of $100m.

b. Is a Section 1031 exchange possible?

(i) TP must acquire replacement property of $100M, funded with TP's cash or new debt. Ex: TP pays $25M down, and incurs $75M new liability, on RP.

(ii) Easiest path is to structure as a deed in lieu of foreclosure with the lender and agree to convey the property in full satisfaction of debt. TP's rights in the "Agreement in Lieu of Foreclosure" can be assigned to QI to start the process.

(iii) If lender will not cooperate and judicial foreclosure ensues, TP should instead assign all rights under the deed of trust and any legal documents of conveyance and other court orders to the QI.

c. Treas. Reg. 1.1031(k)-1(g)(4)(iv) provides guidance on how to get the QI involved: Either:

(iv) **QI Takes Title Theory**: (A) "… intermediary acquires and transfers legal title to that property …"

(v) **QI Assignment Theory:** (B) "intermediary … enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property …"; (C) "intermediary … enters into an agreement with the owner of the replacement property for the transfer of that property …." For this purpose, "an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property".

d. In a deed-in-lieu of foreclosure, normally there is an agreement that can be assigned. PLR 201302009.

e. What about a judicial or involuntary foreclosure?

(vi) Does the QI have to take title? Does that make a loan default? Does it make existing default worse?

(vii) Under IRC 1001, it's a *deemed* sale, but no actual agreement to sell. What can you assign? Deed of Trust? Foreclosure proceeding itself (e.g., reference to court-assigned cause number)? Notice of Trustee Sale? Something else?

3. Section 1031 Exchanges and Options

Example: TP is a developer who has acquired an option to purchase a 20 acre site in Texas, close to a power generation facility that would be ideal for a battery storage site, at a $5M strike price (paying a $500,000 option premium). TP would like to develop the battery storage facility. However, a larger battery storage developer has offered TP $20M for the site.

If TP accepts, can the transaction be structured as a 1031 exchange?

a. Possibly. Options to purchase real property are treated as real property now under 2020 final regulations. Treas. Reg. Sec. 1.1031(a)-3(a)(5)(i).

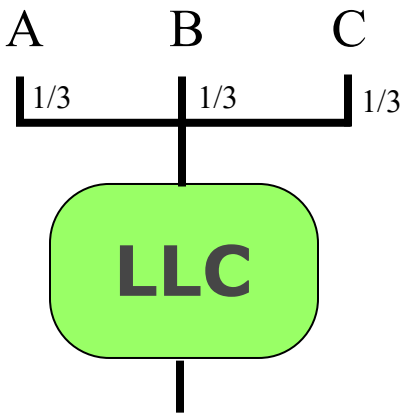
b. However, an open question exists as to whether options are of "like kind" to any other type of real property (such as a fee interest) or whether they are like kind only to other options. *See* Starker v. U.S., 602 F.2d 1341 (9th Cir. 1979) (exchange of contractual right to receive property for a fee interest); FSA 1995-12 (exchange of land for an option to acquire land).

c. TP has two primary options: (1) close, pay $5M for the land, and then immediately re-sell the land for $20M, or (2) sell the option to the developer for $15M. Which way is better?

d. Are rights to purchase under a PSA treated the same as an option?

4. Partnership Structures

a. Same Day Drop & Swap



NYC Apartments

(i) Cases: In the Matter of the Petition of Hadar (DTA No. 850122); In the Matter of the Petition of Shomron (DTA No. 850123). New York Division of Tax Appeals, June 12, 2025.

(ii) Facts

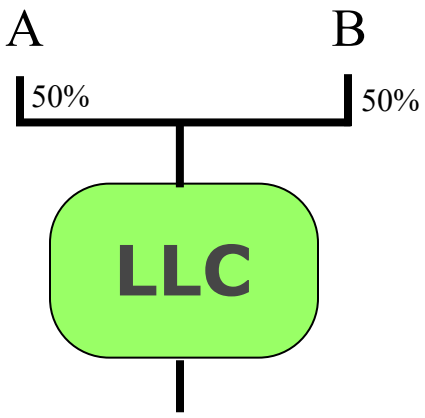
- Members desired to cause LLC to sell NYC apartments for $65M.
- A&B desired 1031; C had stepped-up basis and desired cash.
- A&B expressed a desire to 1031 from the outset, and distribution of TIC interests was always the plan, and buyer was aware. However, LLC entered into the PSA, which was assignable to the members.
- *On date of sale*, LLC distributed TIC interests to Members, who sold as TICs; deeds were filed, lender was notified, NY transfer tax forms were filed, the members entered into a TIC Agreement, and the PSA was assigned to the TICs. A&B did individual 1031s; C cashed-out.
- But TICs reported no property income or expenses (b/c same day).

(iii) NY asserted that the LLC was the true seller of the apartments, that the TICs needed to hold the TIC interests for a "minimum of a couple of months," and that the 1031 failed.

(iv) Court disagreed and held for TPs, finding:

- TICs had a brief holding period, but 1031 has no fixed holding period requirement.
- 1031s preceded by tax-free contributions or distributions have been allowed in various contexts. *Bolker, Magneson, Maloney, Mason*.
- "Held For" test not an issue because under *Bolker*, the intent to exchange property for like kind property meets the test.
- Members had a good business purpose – to separate from each other and acquire individual assets.
- Decision does not discuss *Court Holding* or *Cumberland*.

b. Revenue Ruling 99-6 Transactions: Buy Side



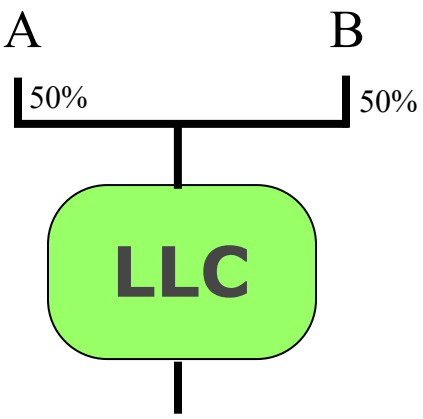
Real Property $100 FMV

(i) A wishes to purchase B's 50% LLC interest for $50 using 1031 cash.

(ii) Under Rev. Rul. 99-6, A is treated as purchasing an undivided 50% interest in the LLC assets, so this can be a good 1031 exchange for A. PLR 200807005.

(iii) Can also be structured using a reverse exchange. *See* PLR 200909008. If using a reverse exchange structure, the EAT will become a real partner in LLC during the parking period. Income allocation may be an issue.

c. Revenue Ruling 99-6 Transactions: Sell Side



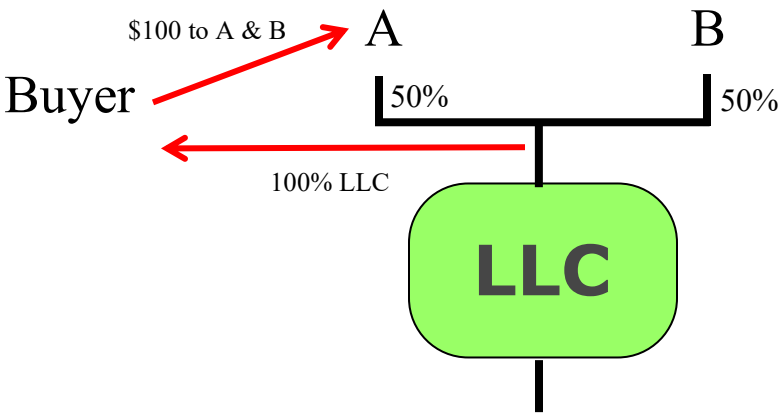
Real Property $100 FMV

(i) B desires to purchase A's 50% LLC interest for $50, but A only wants to sell if structured as a 1031 exchange. Can this work?

(ii) Distribute 50% TIC interest to A, which A then sells to B? Perhaps, but beware *Crenshaw v. United States*, 315 F. Supp 814 (N.D. Ga. 1970).

(iii) Alternative: B contributes $50 to LLC, LLC purchases replacement property A desires, and then LLC distributes such property to A in complete redemption of A's interest under Section 731. See *Countryside Limited Partnership v. Comm'r*, T.C. Memo. 2008-3.

d. Revenue Ruling 99-6 Transactions: The "TopCo"



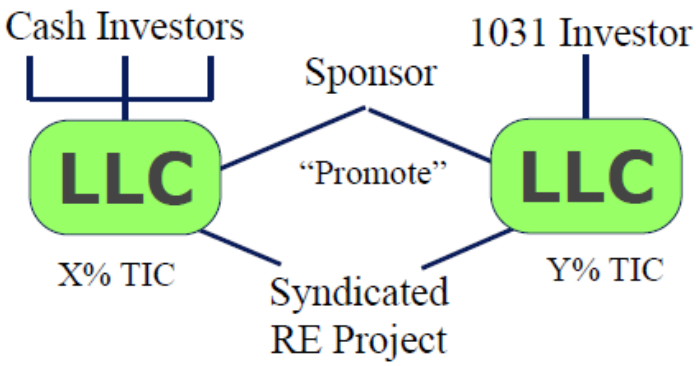
Real Property $100 FMV

(i) Buyer wants to purchase the entire LLC from A and B for $100 for *ad valorem* tax reasons. However, A and B want to sell via a 1031 exchange. How can this work? (See Rev. Rul. 99-6: A and B treated as selling partnership interests).

(ii) First, A and B form a mirror image "Newco" and contribute 100% of LLC to Newco. Newco is a "continuation" of prior LLC partnership, and LLC becomes a "disregarded entity" of Newco.

(iii) Second, Newco sells 100% of DRE LLC and starts a 1031 exchange.

e. Syndicated Transactions

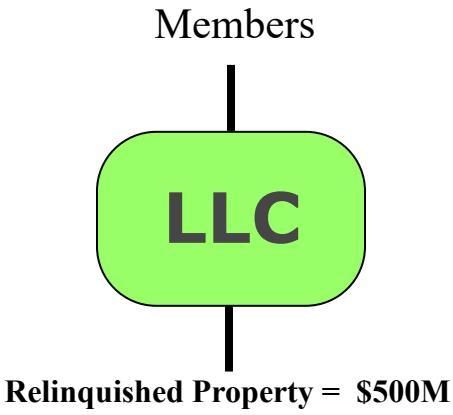


(i) How to accommodate a 1031 investor into a syndicated RE offering typically structured as an LLC or LP investment?

- Usually a TIC structure, at least initially, is the solution.
- Will the lender consent?
- Required roll-up after closing? How long must TP wait?
- How to address the sponsor's promote?

5. Reverse Exchange Planning

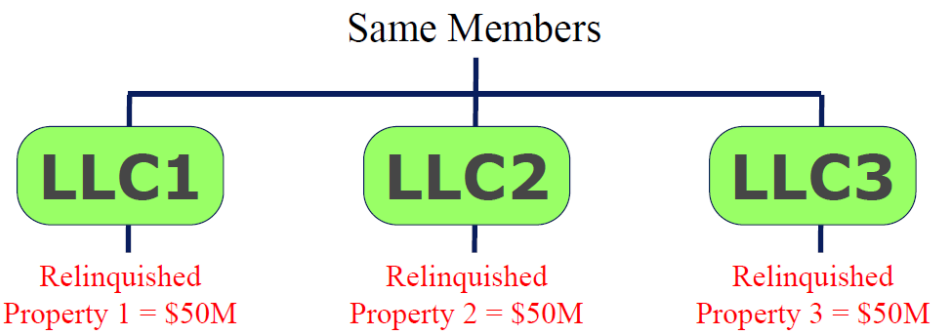
a. Combination Forward & Reverse Exchange



(i) Similar situation as the last slide, but now TP sells RQ for $100, and identifies RP for $250, closing in 30 days. TP also anticipates selling a second, unrelated RQ in around 90 days for $150, and would like to structure this disposition as a 1031 exchange as well using the same RP. Can this be done?

(ii) Solution: Structure as a combination forward and reverse exchange. Step 1 – TP closes exchange #1 by purchasing a 40% TIC interest in the RP. At the same time, TP funds EAT with $150 and EAT purchases the other 60% TIC interest in the same RP. Step 2 – on day 90, TP sells RQ #2 and uses the $150 proceeds to purchase the parked 60% TIC interest in RP from the EAT.

b. Reverse Exchange: Concurrent QEAAs



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(iii) See PLRs 201242003, 201416006.

c. Reverse Exchange: Remember Bartell v. Commissioner, 147 T.C. 140 (2016)

(i) 2016 Tax Court decision.

(ii) Relied heavily on 9th Cir and 5th Cir precedents.

(iii) Very similar facts as allowed under Rev. Proc. 2000-37.

(iv) However, intermediary was permitted to park the replacement property (upon which a new building was constructed) for up to 17 months!

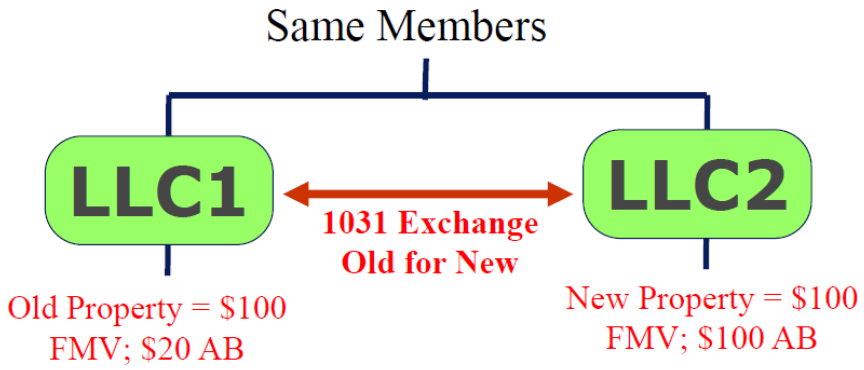
(v) Key Lessons:

- Must intend to do a 1031 exchange;
- Don't take title;
- Use an intermediary.

(vi) IRS chose not to appeal, but also issued an "action on decision" rejecting the legal analysis employed.

6. Proactive Use of Related Parties in 1031 Exchanges

a. Related Parties: Basis Shifting

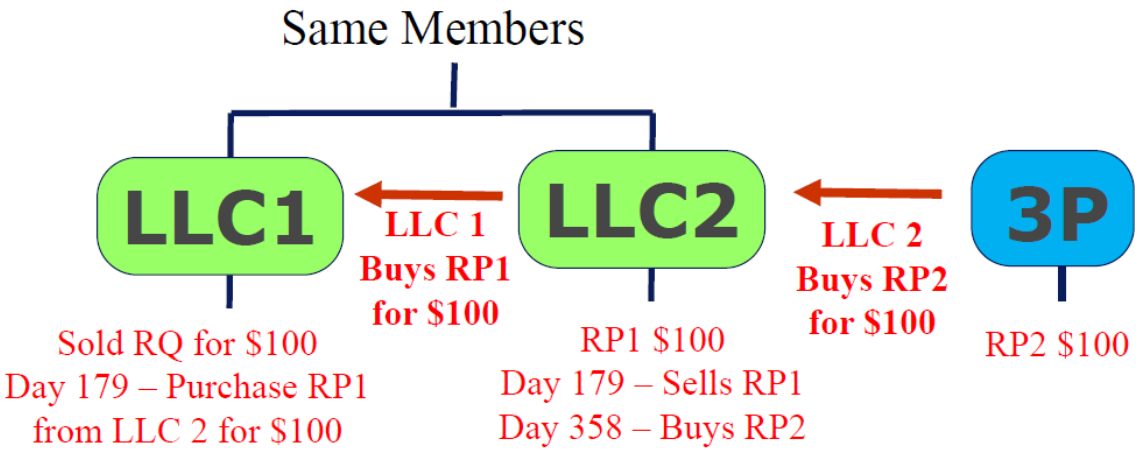


(i) LLC 1 and LLC 2 are related parties. LLC 1 anticipates marketing "Old Property" for sale some time in mid to late 2027. In anticipation of this sale, LLC 1 and LLC 2 exchange properties so that LLC 2 now owns "Old Property" with AB of $100 (i.e., basis has shifted).

(ii) The 1031 exchange can be valid if LLC 1 and LLC 2 both remain invested in their respective replacement properties for at least 2 years. 1031(f)(1)(C).

(iii) Parties must also beware 1031(g)(1) – substantial diminution of risk (e.g., entering into a binding PSA prior to the required 2 years).

b. Related Parties: Saving a Forward



(i) LLC 1 and LLC 2 are related parties. LLC 1 started a forward 1031 exchange 179 days ago, identified 3 RPs (RP1 owned by LLC 2), and has failed to close yet.

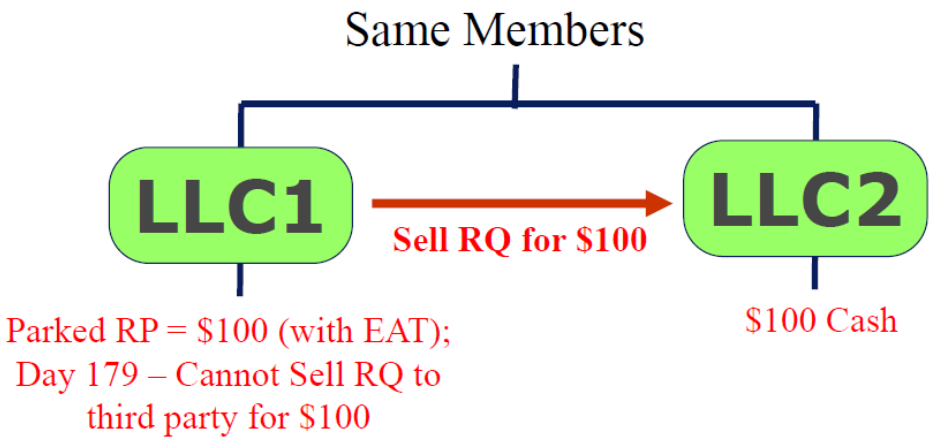
(ii) So, on day 179, LLC 1 will purchase RP1 from LLC2 to complete the 1031 exchange.

(iii) Normally purchasing RP from a related party results in a failed 1031 exchange. Rev. Rul. 2002-83.

(iv) However, if LLC 2 does its own back-to-back 1031 exchange and purchases RP2 for $100 from an unrelated third party, and LLC 1 and LLC 2 each remain invested in their RPs for 2 years, LLC 2 also can have a good 1031 exchange.

(v) See PLRs 201220012, 201216007, 201048025, 200820025, 200820017.

c. **Related Parties: Saving a Reverse**



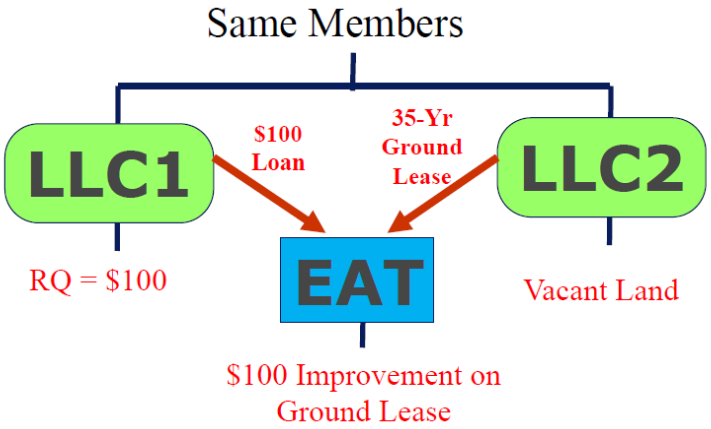
(i) LLC 1 and LLC 2 are related parties. LLC 1 started a reverse 1031 exchange 179 days ago, and has a $100 RP parked with an EAT. LLC 1 has been unable to sell its identified RQ for $100.

(ii) So, on day 179, LLC 1 sells the RQ to LLC 2 (related party) for $100, which goes to the QI account, which then funds the purchase of parked RP for $100.

(iii) See PLRs 200709036, 200712013, 200728008, 201027036.

(iv) Note that this structure works for an "exchange last" reverse where the replacement property is parked with the EAT, but does not work for an "exchange first" reverse where the relinquished property is parked with the EAT.

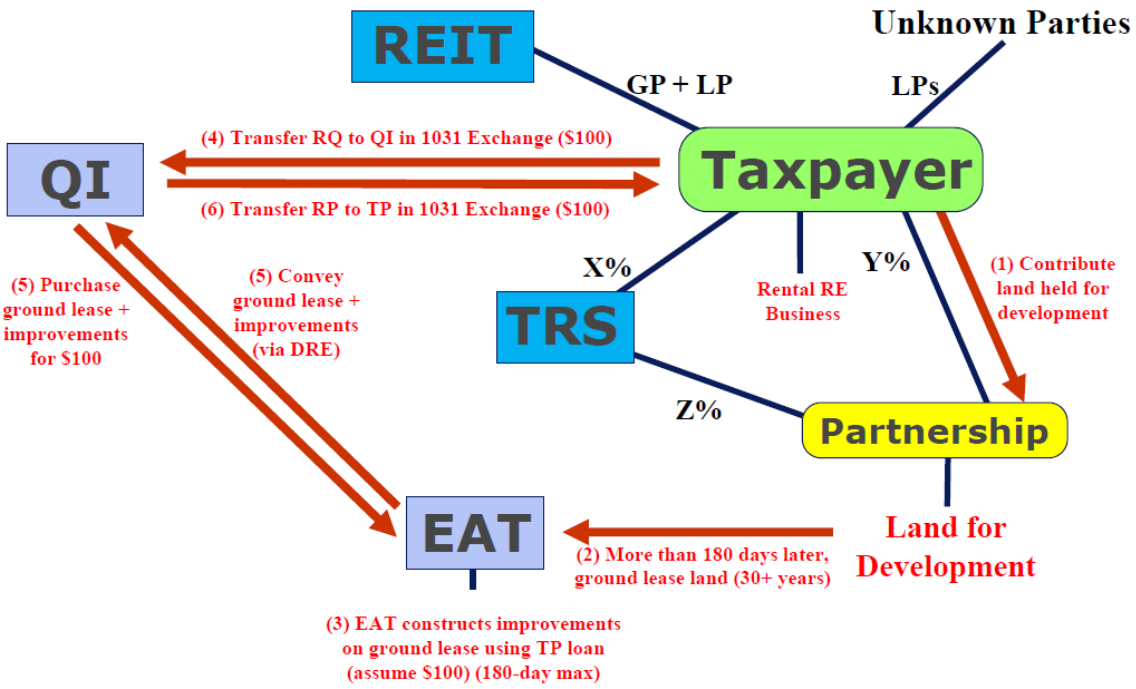
d. Related Parties: Build-to-Suit



(i) LLC 1 desires to sell RQ for $100 and use $100 to build a new plant or rental property. LLC 1 cannot build on land it already owns. *Bloomington Coca-Cola Bottling Co. v. Comm'r*, 189 F.2d 14 (7th Cir. 1951).

(ii) But LLC 1 can build on land owned by LLC 2 if structured as a ground lease of more than 30 years. See PLRs 200251008, 200329021, 201408019.

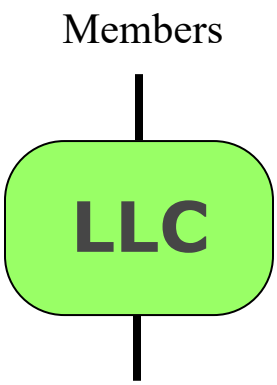
e. PLR 202520001 (May 16, 2025)



(i) **Issues:**

- 1031(f)(1);
- 1031(f)(4);
- Rev. Proc. 2004-51;
- Business purpose: separation of business operations in specific geographic territories

7. Exchange Bifurcation



Relinquished Property = 5 Industrial Buildings (FMV $20M each; AB $4M each)

a. TP has a deal to sell a package of 5 discrete industrial properties to a single buyer at a total price of $100M (each site is valued at $20M). Basis is $20M ($4M per site). Should TP structure as a single $100M exchange? Or as 5 separate $20M exchanges?

b. Why bifurcate? Key benefit is flexibility to allow some of the exchanges to fail and become taxable sales, with full basis offset per site.

c. Factors favoring bifurcation:

(i) Breaking up the transaction into multiple PSAs;

(ii) Staggering the closing dates;

(iii) Sales to different buyers;

(iv) Separate facilities acquired at separate times;

(v) Using different QI for each 1031 exchange.

SECTION 1031 EXCHANGES IN THE OIL & GAS SECTOR

Todd D. Keator
Deloitte Tax LLP
Dallas, TX

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SECTION 1031 EXCHANGES IN THE OIL & GAS SECTOR

Todd D. Keator
Deloitte Tax LLP[1]
Dallas, TX

I. Introduction

Domestic oil and gas exploration and production continues to rise. For example, Texas produced more than 2 billion barrels of oil in 2023 and 2024, which is a significant increase over recent years.[2] Naturally, the increase in U.S. exploration and production activity has been accompanied by a corresponding increase in oil and gas acquisitions and divestitures. In many cases, these transactions are structured (or intended to be structured) as tax deferred exchanges under Code Section 1031 (a "1031 Exchange").[3] Investors considering using a 1031 Exchange as a means to dispose of or acquire oil & gas properties should consider several key issues that can impact the transaction, including:

- The types of oil & gas interests that qualify for a 1031 Exchange;
- Whether the transaction will be respected as an "exchange" or recast as a leasing transaction (and ineligible for 1031 Exchange treatment);
- The impact of IDC and depletion recapture in the exchange;
- The presence of a "tax partnership" and the need to elect out of subchapter K in order to utilize a 1031 Exchange; and
- The effect of oil and gas unitizations under Section 1031.

This outline will discuss certain tax issues surrounding these 1031 Exchanges of oil and gas assets.

II. Background

As a general rule, gain from the sale or exchange of property must be recognized for federal income tax purposes.[4] The gain that must be recognized is the excess of the amount realized from the sale or

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[2] https://rrc.texas.gov/oil-and-gas/research-and-statistics/production-data/texas-monthly-oil-gas-production.

[3] All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code").

[4] I.R.C. § 1001(a).

exchange over the taxpayer's adjusted basis in the property sold or exchanged.[5] Code Section 1031(a)(1) provides an exception to the general rule for exchanges of "like kind" properties held for productive use in a trade or business or for investment (a "1031 Exchange"). According to that section:

> No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real 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.[6]

Note the three elements of the test: (1) there must be an "exchange" of properties; (2) the properties must be held for use in a trade or business or for investment; and (3) the properties must be of "like kind."

The underlying rationale for allowing nonrecognition of gain or loss is the concept that the taxpayer's economic situation after the exchange is fundamentally the same as it was before the transaction.[7] This is expressed in the Committee Report to the predecessor statute to Code Section 1031 as follows:

> [I]f the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit.[8]

Although not explicitly stated in Section 1031, the same taxpayer that commences a 1031 Exchange by disposing of relinquished property must finish the 1031 Exchange by acquiring replacement property.[9] However, acquisitions via a "disregarded entity" – such as a single member LLC – would satisfy the "same taxpayer" requirement.

III. Oil and Gas Interests in a 1031 Exchange

A. Whether Oil and Gas Assets are of "Like Kind"

Treasury Regulation Section 1.1031(a)-1(b) provides that, as used in Code Section 1031(a)(1), the term *like-kind* refers to the nature or character of the property, not to its grade or quality.[10] One kind or class of property may not be exchanged for property of a different kind or class. For example, a taxpayer cannot exchange real property for personal property because the nature or character of the property is not of like-kind. However, real property generally is considered to be like-kind to all other real property, regardless of how different the property interests may seem.[11]

Example 1. Liam the Landman has worked diligently to assemble a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases). Liam has decided that he wants

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[5] *Id.*

[6] I.R.C. § 1031(a)(1).

[7] *See* Clemente, Inc., T.C. Memo. 1985-367; Koch v. Comm'r, 71 T.C. 54 (1978); T.A.M. 9525002 (June 23, 1995).

[8] H. Rept. 704, 73d Cong., 2d Sess. (1934); 1939-1 C.B. (Part 2), 554, 564.

[9] *See* Chase v. C.I.R., 92 T.C. 874 (1989).

[10] Treas. Reg. § 1.1031(a)-1(b).

[11] Comm'r v. Crichton, 122 F.2d 181 (5th Cir. 1941).

out of the oil business and has negotiated to exchange the entire working interest for a ranch that he will hold for investment purposes. Can Section 1031 apply to the transaction?

The answer is yes. A working interest in oil and gas is considered an interest in real property and may be exchanged for other real estate in a 1031 Exchange. On numerous occasions, the IRS has found that an unlimited economic interest to the minerals in place is a real property interest for federal tax purposes, so long as the interest is for an unlimited duration.[12] Generally, state law defines whether an interest in property is real or personal.[13] However, due to the dramatic disparities in state law treatment of mineral interests, multiple revenue rulings have decided that state law is not determinative of whether an oil and gas interest qualifies as real property for purposes of Code Section 1031.[14] According to these rulings, federal law, independent of state law considerations, should determine the nature of an oil and gas interest. In so ruling, the IRS determined that "economic interests" in oil, gas, and other minerals, including leasehold interests, working interests, royalty interests, and overriding royalty interests, are all considered real property for purposes of Code Section 1031,[15] regardless of the state law characterization.[16]

As real property interests, oil and gas interests are of like kind and can be exchanged for other oil and gas interests or other types of real property (e.g., land and buildings) pursuant to a 1031 Exchange. The interest may be exchanged for other kinds of real property without recognition of gain.[17] Some examples from published guidance include:

[12] *See* Palmer v. Bender, 287 U.S. 551 (1933); Rev. Rul. 68-226, 1968-1 CB 362.

[13] Aquilino v. U.S., 363 U.S. 509 (1960).

[14] Rev. Rul. 68-226, 1968-1 CB 362; Rev. Rul. 88-78, 1988-2 CB 330.

[15] See GCM 39572 ("[b]ecause this standard has been liberally construed, the replacement of one real property interest held for productive use in trade or business or for investment by another that is similarly held generally would be deemed to fall within the definition of a like-kind exchange."); Rev. Rul. 68-226, 1968-1 CB 362 ("the interest of a lessee in oil and gas in place . . . is an interest in 'real property' for Federal income tax purposes . . ."); Rev. Rul. 88-7, 1988-2 CB 330 ("the disposition of oil rights is the disposition of an interest in real property."); Rev. Rul. 73-428, 1973-2 CB 303 ("A royalty interest in oil and gas in place is a fee interest in mineral rights and real property for Federal income tax purposes."); GCM 34033 (An "overriding royalty and . . . working interest are both considered interests in real property for purposes of the Federal income tax."); Rev. Rul. 72-117, 1972-1 CB 226 ("[O]verriding oil and gas royalties are interests in real property.").

[16] I.R.M., Oil and Gas Handbook, 4.41.1.4.1 (last revised July 31, 2002). Moreover, the Internal Revenue Manual provides that "[a]n interest in an oil and gas lease is an interest in 'real property' for Federal income tax purposes (Rev. Rul. 68-226). This ruling applies in all cases, regardless of how the oil and gas lessee's interest is treated under state law." *See also* Treas. Reg. § 1.1031(a)-3(a)(3) (real property includes "unsevered natural products of land" including "mines; wells; and other natural deposits").

[17] However, if relinquished property constitutes a developed interest in mineral reserves and the replacement property is not a similar interest, the recapture of prior intangible drilling costs and depletion deductions cannot be deferred. *See* discussion of Section 1254 recapture, below.

- An exchange of undivided interest in hotel for mineral properties;[18]
- An exchange of undivided interest in unimproved real estate for interest in overriding oil and gas royalties;[19]
- An exchange of working interests in two leases;[20]
- An exchange of interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch;[21] and
- An exchange of overriding royalties for unimproved real estate.[22]

Example 2. Drillco finds itself in a liquidity crisis and does not have sufficient capital to develop the 75% working interest in approximately 10,000 acres that it acquired from Liam the Landman. Therefore, to provide Drillco with a steady stream of income, Drillco has negotiated with Darren the Driller to exchange the entire working interest for "production payments" burdening Darren's other oil and gas wells. The terms of the production payments provide that Drillco will receive a fixed percentage of all revenues from Darren's other wells until Drillco has received a total payment of $100X, at which point the payments will cease. Can Section 1031 apply to Drillco's transaction?

No, a production payment is generally considered to be personal property because it is simply an assignment of income. Therefore, a production payment is not of like-kind to real property interests.[23] The main distinction between a production payment and a royalty is the duration of the interest. A royalty or overriding royalty continues until the mineral deposit is exhausted whereas a carved-out oil production payment right terminates usually when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received. Thus, because a production payment is of limited duration, it is not considered an interest in real property and so cannot be of like kind to other types of real property.

In other instances where the oil and gas interest to be exchanged is of limited duration, the IRS also has found that the interests *do not* qualify for 1031 Exchange treatment. Specific examples include:

[18] *See* Comm'r v. Crichton, 122 F.2d 181 (5th Cir. 1941).

[19] GCM 34651.

[20] Rev. Rul. 68-186, 1968-1 CB 354.

[21] Rev. Rul. 68-331, 1968-1 CB 352.

[22] Rev. Rul. 72-117, 1972-1 CB 226.

[23] *See* I.R.C. § 636; Comm'r. v. P. G. Lake, Inc., 356 U.S. 260 (1958).

- An exchange of a limited oil payment right for an overriding oil and gas royalty reserved from the same lease;[24]

- An exchange of a leasehold measured in terms of a fixed percentage of all oil that might be produced from certain lands for leasehold measured in terms of a fixed number of barrels of oil;[25] and

- An exchange of carved-out oil payment rights *of limited duration* for a fee interest in a ranch.[26]

B. The "Sale vs. Lease" Issue

Of all the "gotchas" in 1031 Exchanges involving oil and gas, the sale vs. lease question is probably the most important. In many situations, a transaction that for all purposes looks to be structured as a sale or 1031 Exchange will instead be recast as a leasing transaction for federal tax purposes. If recast as a lease, any upfront consideration is ordinary income, and ineligible to be used in a 1031 Exchange. It is paramount to understand the circumstances in which an exchange may be recast as a lease, and the steps that can be taken to prevent this result.

Example 3. Drillco owns a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases). Drillco has negotiated a deal to sell the entire working interest to "Buyer" for $100,000,000, plus Drillco will retain an overriding royalty ("ORRI") equal to 25% less all landowner royalties burdening the leases. Thus, for example, on leases burdened by a 20% landowner royalty, the retained ORRI will equal 5%, but on leases burdened by a 25% landowner royalty, Drillco will retain no ORRI. Drillco intends to reinvest the entire $100,000,000 in "like kind" property pursuant to a 1031 Exchange. Is this a valid 1031 Exchange?

The answer is yes and no, because the answer is determined on a lease-by-lease basis.[27] The answer is yes for any lease for which Drillco retains no ORRI. However, the answer is no for any lease upon which Drillco retains the ORRI.[28] The reason is that, for any leases upon which Drillco retains an ORRI, the transaction with respect to those leases will be treated as a leasing transaction, and not as a sale or exchange, for federal tax purposes.[29] Therefore, the portion of the $100,000,000 payment allocable to the leasing transaction will be treated as lease bonus, which is ordinary income and ineligible for reinvestment via a 1031 Exchange.

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[24] Midfield Oil. Co. v. Comm'r., 39 BTA 1154 (1939).

[25] Bandini Petroleum Co. v. Comm'r., PH TCM P 51310 (1951).

[26] Fleming v. Comm'r., 24 T.C. 818 (1955) a "horizontal" carve-out would be an anticipatory assignment of income from a contractual arrangement, not an exchange of an economic interest in the property.

[27] *See* Cullen v. Comm'r, 118 F.2d 651 (5th Cir. 1941) (whether a sale or lease occurs must be determined on a property-by-property basis).

[28] *See* Crooks v. Comm'r, 92 T.C. 816 (1989) (transaction was a lease, not a sale or exchange, where taxpayer conveyed mineral rights under an existing farm in exchange for four additional farms plus retention of a royalty burdening the conveyed mineral rights; retention of the royalty converted the transaction into an ordinary leasing transaction).

[29] *Id*. *See also* Rev. Rul. 69-352, 1961 C.B. 34.

Crooks v. Commissioner[30] is the seminal case on point for the sale vs. lease issue. In that case, the taxpayer owned a farm under which oil and gas was discovered. The taxpayer exchanged the mineral rights to an oil and gas development company in exchange for (1) four other farms and (2) a retained 25% royalty on all production achieved on the mineral rights conveyed. The court held that because the taxpayer retained the royalty interest on the mineral rights disposed of, the transaction was a lease of the mineral rights, not a complete disposition, and therefore Section 1031 did not apply. Thus, the key rule is that if a taxpayer retains a continuing non-operating interest in oil and gas rights conveyed, the transaction is a leasing transaction, not a sale or exchange, for tax purposes.

Many clients in this situation are surprised to learn that, by retaining an ORRI on a purported sale of working interests, not only is the transaction ineligible for 1031 Exchange treatment, but the gain on sale is no longer long-term capital gain, but instead is ordinary income in its entirety. The rationale for this treatment is simple. Drillco, by reserving the ORRI in one or more of the leases, merely grants to the Buyer exclusive exploitation privileges, and retains as its share of the oil and gas in place that portion which, freed of the burdens of development and operation costs, has a value equivalent to the value of the entire interest subject to such burdens.[31] Therefore, Drillco is not regarded as having disposed of a capital asset, and so the upfront consideration is viewed as ordinary bonus income.

Upon learning this information, Drillco comes to you to ask what can be done to fix the situation and allow Drillco to structure the disposition as a 1031 Exchange? At this stage, the likely choices are to restructure the business deal such that Drillco either (a) retains no ORRI and the parties increase the cash consideration commensurately, (b) retains no ORRI and sells a smaller working interest for the same cash consideration, or (c) redefines the terms of the retained ORRI such that it is no longer treated as a "royalty" for federal tax purposes (e.g., use a term shorter than the expected life of the burdened properties such that the ORRI will be treated as a production payment instead of a royalty).[32]

Example 4. Same as example 3, but now assume that Drillco has pre-negotiated a deal to sell the retained ORRI at closing to a separate buyer for a separate $25,000,000 payment. Can Drillco use the entire $125,000,000 in a 1031 Exchange?

The answer is likely yes. Because Drillco now will dispose of its entire interest in the leases pursuant to a single, integrated transaction, the transaction should be respected as a sale or exchange, instead of being treated as a lease.[33]

Example 5. Same as example 3, but now assume that as Drillco assembled the 10,000 acre working interest, Drillco periodically carved off the ORRI and assigned it to its separate taxpayer affiliate Royaltyco in order to shield the valuable royalty rights from potential liabilities associated with Drillco's riskier

[30] 92 T.C. 816 (1989).

[31] For a detailed discussion of this theory, *see* GCM 22730, 1941-1 C.B. 214.

[32] *See, e.g.,* Cullen v. Comm'r, 118 F.2d 651 (5th Cir. 1941) (sales of leases coupled with retained production payments respected as sales for federal tax purposes); PLR 9437006 (retained production payments). However, caution should be exercised if retaining a production payment on "wildcat" acreage, because the production payment in this instance will likely be treated as a royalty for federal tax purposes. *See* Watnick v. Comm'r, 90 T.C. 326 (1988).

[33] *See* FSA 1999-819, Vaughn # 223 (sales of working interests to third parties, coupled with reservation of ORRIs and contemporaneous assignment of the ORRIs to a trust for the benefit of the seller's children, respected as sales of the working interests for federal tax purposes).

exploration and production activities. Thus, when Drillco finally negotiates the deal to sell the working interest to Buyer for $100,000,000, the sale will be subject to the pre-existing ORRIs that reside in Royaltyco, and so the ORRI will not be carved out and retained at the closing of the sale. Is Drillco's sale now eligible for a 1031 Exchange?

Application of a 1031 Exchange to these facts is certainly more likely than in the base case of example 3. Now, under the form of the transaction, Drillco has not retained the ORRI as part of the same transaction in which the working interest was sold, and instead has sold the working interests subject to a pre-existing ORRI, and so the rationale of *Crooks* is not applicable on its face. However, substance over form or step transaction doctrine principles could still apply to integrate the steps of the transaction such that the sale or exchange may still be characterized as a leasing transaction for federal tax purposes. Thus, taxpayers planning to structure dispositions to yield sale or exchange treatment, while retaining an ORRI on the interests conveyed in an affiliate, should have bona fide business purposes for the ORRI or royalty conveyances and should make such conveyances as far in advance of closing as possible.

Example 6. Same as example 3, but now assume that Drillco instead negotiates a deal to sell 50% of its 75% working interest (i.e., a 37.5% working interest) to Buyer for $50,000,000, thereby retaining a 37.5% working interest, and Drillco will not retain any ORRI. Drillco intends to reinvest the $50,000,000 proceeds in a 1031 Exchange. Can this work?

Yes. Although Drillco has retained 50% of the working interest, it has disposed of the entire 37.5% working interest sold to Buyer, and has not retained any economic interest burdening the portion that was transferred.[34] Thus, the situation is distinguishable from *Crooks* and other cases involving a retained royalty. The difference is that Drillco has sold a "vertical slice" of the entire working interest, and has not retained an economic interest in the vertical slice that was sold, whereas in Example 5, Drillco retains an economic interest burdening the interest conveyed to Buyer. As a result, in Example 7, Drillco may initiate a 1031 Exchange with the sale proceeds.[35]

C. Recapture Issues

Oil and gas interests raise special recapture issues in the 1031 Exchange context. While oil and gas properties generally are of like kind to any other type of real property, including land and buildings, oil and gas properties typically carry special recapture attributes that may only be deferred where the replacement property consists of other oil and gas properties. Thus, where oil and gas properties are exchanged for land and buildings in a 1031 Exchange, recapture becomes a significant issue.

Example 7. Wildcatter Warren owns a working interest upon which he previously drilled three successful operating wells. Warren previously took intangible drilling cost (IDC) deductions of $500,000 and depletion deductions of $600,000 with respect to the working interest. At a time when Warren's adjusted basis in the working interest is $0, Buyer offers to purchase the working interest from Warren for $2,000,000. Warren finds the price particularly attractive, but would prefer to reinvest the sales proceeds in another producing oil and gas property on a tax-free basis. On the other hand, his wife, Mrs. Warren, has her eye on a Montana ranch. Furthermore, their son, Junior Warren, proposes that the family invest in

[34] *See* Berry Oil Co. v. U.S., 25 F. Supp. 96 (Ct. Cl. 1938); Ratliff v. Comm'r, 36 BTA 762 (1937).

[35] It should be noted that the same would be true if Drillco instead were to sell 50% of a royalty, instead of a working interest. *See* Ratliff v. Comm'r, 36 BTA 762 (1937) (sale of one half of a royalty respected as a sale and not treated as a leasing transaction). Again, the fundamental point is that the interest being sold is a fractional interest identical with the fractional interest being retained (except as to the quantity being sold), such that no "economic interest" is retained with respect to the interest being sold.

a recently discovered (and yet undeveloped) shale gas play (he is very bullish on natural gas prices). Warren calls you to discuss his options for a 1031 Exchange.

Recall that Warren previously took IDC deductions of $500,000 and depletion deductions of $600,000 with respect to the working interest. If Warren sells the working interest for cash, Warren will recognize gain of $2,000,000 under Section 1001. Furthermore, $1,100,000 of such gain will be recaptured as ordinary income under Section 1254, which requires recapture in an amount equal to the lesser of prior deductions ($1,100,000) or gain from the sale ($2,000,000).[36] The remaining $900,000 of gain will be taxed as long-term capital gain, assuming Warren has held the property for investment for more than one year.[37] (Note, that if Warren receives cash at any point, even if it is later reinvested in other property, Warren cannot utilize a 1031 Exchange to defer recognition of the gain and, thus, recapture of the previously deducted amounts.)

Alternatively, assume that Warren sells the working interest and deposits the $2,000,000 with a "qualified intermediary" for use in a 1031 Exchange. Warren intends to invest all $2,000,000 in another producing working interest. Here, Warren would recognize no gain pursuant to the 1031 Exchange. With respect to recapture, there is an exception if both the relinquished and replacement properties qualify as "Section 1254 property." Section 1254 property includes property that has been subject to IDC or depletion deductions. Under the exception, because the relinquished property and the replacement property both are producing working interests that qualify as "Section 1254 property," Warren will recognize no recapture at the time of the sale under Treasury Regulation § 1.1254-2(d). Instead, the recapture will be deferred and carry over to the replacement property, under Treasury Regulation § 1.1254-3(d). Note that if Warren had reinvested only $1,900,000 in the replacement working interest and retained $100,000 at closing, the $100,000 of cash boot received would be recognized as ordinary income under the Section 1254 recapture rules, and deferred recapture of $1,000,000 would carry over to the replacement working interest under Treasury Regulation § 1.1254-3(d).

Updating the facts, assume that Warren sells the working interest and utilizes a 1031 Exchange to reinvest all $2,000,000 of proceeds in the Montana ranch, which Warren intends to hold for investment purposes. As before, Warren would recognize no gain pursuant to the 1031 Exchange, because the relinquished working interest and the Montana ranch are like kind real property. Nevertheless, Warren would be required to recapture as ordinary income all $1,100,000 of prior IDC and depletion deductions because the ranch is not Section 1254 property.[38] This example illustrates the point that Section 1254 recapture is another big "gotcha" in oil and gas 1031 Exchanges because even though a transaction may fully qualify under Section 1031, the 1254 recapture potentially may all be taxed, thus negating or reducing the benefit of the 1031 Exchange.

Given this result, Warren asks whether he can roll $500,000 into the Montana ranch using a Section 1031 exchange, with a mortgage for the balance of the $2,000,000 purchase price. This would leave $1,500,000 of sales proceeds to exchange into another producing working interest. Warren asks how the recapture rules apply in this scenario. Now, Warren would recognize no gain in connection with the 1031 Exchange, because the relinquished working interest and replacement property (consisting of the Montana ranch and the working interest) are of like kind. As before, Warren would be required to recapture as ordinary income $500,000 of prior IDC and depletion deductions related to the Montana ranch because the

[36] I.R.C. § 1254(a)(1).

[37] I.R.C. § 1222(3).

[38] Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2).

ranch is not Section 1254 property.[39] On the other hand, because $1,500,000 of the replacement property is a producing working interest (and Section 1254 property), the remainder of the recapture ($600,000) would be deferred and would remain preserved in the replacement working interest under Treasury Regulation § 1.1254-3(d).

Finally, Warren asks you about Junior's idea. Junior Warren has been attending seminars on emerging shale gas plays, and thinks there are tremendous opportunities acquiring undeveloped "wildcat" leases rather than producing working interests. Based on your conversation so far, Warren assumes that the exchange would qualify under Section 1031, and that he could avoid any recapture. You though are less confident. The answer depends on whether *undeveloped* leases constitute "section 1254 property," as defined. The primary authority is Treasury Regulation § 1.1254-2(b)(2)(iv)(A), which defines property as "section 1254 property" in part as property "if any expenditures described in paragraph (b)(1)(i)(A) of this section (relating to costs under section 263, 616, or 617) are *properly chargeable to such property*."[40] The costs referred to include IDCs. Furthermore, the regulations instruct that an expenditure (such as IDC) "is properly chargeable to property if—(1) The property is an operating mineral interest with respect to which the expenditure *has been deducted*."[41] The use of past-tense language *could* mean that undeveloped working interests that have never had any IDCs associated with them may not qualify as section 1254 property, and if that interpretation is correct, and if such property serves as replacement property in Warren's 1031 Exchange, recapture may be required.

D. Tax Partnerships

Treasury Regulation Section 1.1031(a)-3(a)(5)(i)(C) specifically excludes partnership interests from the realm of a 1031 Exchange. Many oil and gas working interests are owned via tax partnership arrangements. Thus, caution is warranted to determine the status of working interests when contemplating their use in a 1031 Exchange.

Example 8. Producer Paul owns a 75% working interest in Texas leases. Paul sells half of the leases to Buyer for $1,000,000. Paul and Buyer execute a joint operating agreement appointing Paul as the operator of the leases. The first well is a gusher, and a larger oil company approaches Paul to purchase Paul's 37.5% working interest for $10,000,000. Paul is interested in selling, but only if Paul can defer gain via a 1031 Exchange. Is this possible?

On the face of the transaction, the disposition of a 37.5% working interest appears to be eligible for 1031 Exchange treatment, assuming the other requirements of Section 1031 are satisfied.[42] However, by default, the working interest jointly owned and operated by Paul and Buyer creates a partnership for federal tax purposes.[43] Thus, by selling the 37.5% working interest, Paul in fact will be viewed as selling a

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[39] Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2). Note that under taxpayer-favorable ordering rules, the replacement working interest ($1,500,000) is first matched against the relinquished working interest ($2,000,000) in the 1031 Exchange in order to minimize the potential for recapture. *See* Treas. Reg. § 1.1254-2(d)(2). Here, the ordering rules leave only $500,000 subject to recapture.

[40] Treas. Reg. § 1.1254-1(b)(2)(ii) (emphasis added).

[41] Treas. Reg. § 1.1254-1(b)(2)(iv)(A)(1) (emphasis added).

[42] *See, e.g.*, Rev. Rul. 68-331, 1968-1 C.B. 352.

[43] *See* Bentex Oil Corp. v. Comm'r, 20 T.C. 565 (1953); I.T. 2749, XIII-1 C.B. 99 (1934).

partnership interest for federal tax purposes, which prevents Paul from structuring the disposition as a 1031 Exchange.

However, notwithstanding the tax partnership, under Section 761(a), Paul and Buyer may jointly elect out of subchapter K, in which case Paul may proceed with a 1031 Exchange.[44] The election out will be effective on the first day of the taxable year for which the election is made. Under Treasury Regulation § 1.761-2(b)(1), the election must be made on the partnership return for the "first taxable year for which exclusion from subchapter K is desired."[45] Here, if Paul and Buyer make the election for the current year tax return, the election will be effective on January 1 of the current year. Thus, provided the disposition occurs after such date, the disposition should be eligible for 1031 Exchange treatment.

Example 9. Assume the facts are the same as example 8, but now assume that the consideration paid by Buyer for the initial assignment of half of Paul's working interests consisted of $1,000,000 plus Buyer's obligation to pay 100% of the cost to drill the first 5 wells on the leasehold. Buyer and Paul will divide all revenues produced from such wells 50/50. As a practical matter, will Buyer consent to Paul's request to elect out of subchapter K in order to facilitate Paul's 1031 Exchange?

The answer is probably not. Under these facts, the arrangement does not satisfy the "complete payout" rule, and so Buyer would be unable to deduct 100% of the costs it funds to drill the first 5 wells (and instead would be limited to deducting only 50% of those costs).[46] By keeping the tax partnership in place, however, the tax partnership is able to specially allocate 100% of the costs of the first 5 wells to Buyer. Thus, Buyer needs to the tax partnership to remain in place in order to deduct 100% of the IDCs it funds for the initial wells. Therefore, as a practical matter, Paul probably will be unable to obtain Buyer's consent to the election out of subchapter K, meaning Paul cannot presently dispose of the 37.5% working interest as part of a 1031 Exchange.

E. Pooling and Unitization

A natural gas reservoir may extend over several hundred acres. The related mineral interests may be held by multiple owners, who together may have leased such interests to several lessees. To reduce waste and maximize production, many state conservation laws compel lessees within a specified spacing unit to pool their interests in a unitization. Furthermore, lessees holding rights on adjoining tracts commonly form unitizations voluntarily under pooling agreements to maximize production within a given area. Whether under state statute or by voluntary agreement, a unitization raises special issues in the context of a 1031 Exchange.

Example 10. Independent Oil Co. recently leased the 300 acre West tract for a one-eighth royalty. Conglomerate Oil Co. is negotiating a lease for the contiguous 900 acre East tract for a one-sixth royalty. Conglomerate approached Independent about forming a unitization to voluntarily pool the West and East tracts to maximize production from a single underlying mineral deposit. Independent calls to ask if Independent will encounter adverse tax consequences by signing the pooling agreement.

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[44] *See* I.R.C. § 1031(a)(2)(flush language) ("an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.").

[45] Treas. Reg. § 1.761-2(b)(1); Rev. Rul. 83-129, 198-2 C.B. 105.

[46] *See* Rev. Rul. 70-336; Rev. Rul. 71-207.

Under the agreement, the West and East tracts would be unitized under a participation formula that allocates 25 percent of unit production to the West tract (300 West acres divided by 1,200 total acres) and 75 percent of unit production to the East tract (900 East acres divided by 1,200 total acres), in each case burdened by the applicable one-eighth or one-sixth royalty. Independent would be asked to cover its share of the operating costs under the same formula (25 percent). In essence, the agreement calls for Independent to hedge its risk by exchanging its lease of 100% of the West 300 acres for a 25% share of production from the entire 1,200 acre tract.

Does the unitization qualify as a 1031 Exchange? Generally, yes.[47] A unitization generally results in an exchange of a taxpayer's interest in a smaller property for an undivided interest in the overall unit. Generally, a party to a unitization agreement will have a leasehold cost, which would roll over and become the basis for the participating interest in the new unit.[48]

Example 11. Same facts as Example 10, but now assume Independent and Conglomerate are related parties (both affiliates under the same parent organization). One year after the unitization is formed, Conglomerate sells the East tract to a third party in a fully taxable sale.

Because Independent and Conglomerate are related parties, the subsequent disposition within two years of the 1031 Exchange implicates Section 1031(f), which a special accelerated recognition rule that applies to related parties. Generally, under Section 1031(f), where related parties engage in a 1031 Exchange, if either party disposes of the property received in the exchange within two years following the exchange, nonrecognition of gain under Section 1031 shall no longer apply to either party with respect to such exchange.[49]

Notwithstanding the general rule, Section 1031(f)(2) contains exceptions to the accelerated recognition rule in Section 1031(f)(1). For example, under Section 1031(f)(2)(C), the accelerated recognition rule does not apply if the taxpayer can establish that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax. Legislative history clarifies that the non-tax avoidance exception under Section 1031(f)(2)(C) generally will apply when a transaction involves an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties.[50] Although a unitization is basically the inverse situation, *i.e.*, an exchange of single contiguous properties that results in each taxpayer holding an undivided interest in the combined unit, the underlying nontax avoidance purpose may be analogous. Thus, an argument can be made that the accelerated recognition rule in Section 1031(f)(1) should not apply. Given the uncertainty, however, taxpayers in this situation should consider obtaining a private letter ruling, if certainty is required.

[47] Rev. Rul. 68-186, 1968-1 C.B. 354; GCM 33536 (June 19, 1967).

[48] *See* Internal Revenue Manual, Oil and Gas Handbook at § 4.41.1.4.5 (July 31, 2002).

[49] *See* I.R.C. § 1031(f)(1).

[50] *See* H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989); S. Print. No. 56, at 152; PLR 200820017 (May 16, 2008).

IV. Conclusion

1031 Exchanges in the oil and gas sector have been hot in recent years, and all indications are that the trend will continue into the foreseeable future. Taxpayers considering entering into 1031 Exchanges involving oil and gas interests should carefully consider the unique problems that may be encountered in this area. Taxpayers should be advised to consult with reputable tax counsel to help navigate and avoid the various traps that may be encountered with exchanging oil and gas assets.

1031 TRANSACTIONS WITH RELATED PARTIES

By

Todd D. Keator
Deloitte Tax LLP
Dallas, TX

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Todd D. Keator
Deloitte Tax LLP
Dallas, TX

I. Code Section 1031(f) – Purpose of Enactment

A. Purpose. Congress enacted Code Section 1031(f) to prevent abusive basis shifting in property. *See* H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1340 (1989) ("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.").

B. Example of Basis Shifting. A and B are related persons (*e.g.*, father/son; sole shareholder/corporation; two partnerships wholly owned by same person(s), etc.). A owns Skyscraper ($1,000,000 FMV, $0 adjusted basis), and B owns Farm ($1,000,000 FMV, $1,000,000 adjusted basis). Buyer, an unrelated third party, desires to purchase Skyscraper. If A sells Skyscraper to Buyer, A will recognize a $1,000,000 gain. Therefore, in anticipation of the sale to Buyer, A and B exchange Skyscraper and Farm pursuant to Code Section 1031. Under Code Section 1031(d), A takes a $0 basis in Farm, and B takes a $1,000,000 basis in Skyscraper. Shortly after the exchange, B sells Skyscraper to X. Because B's amount realized and basis are both $1,000,000, B recognizes no gain on the sale. A and B have thus shifted bases in order to avoid gain on the sale of Skyscraper. Code Section 1031(f) prevents this result by denying like kind exchange treatment for the exchange between A and B.

II. Code Section 1031(f) – Mechanics

A. General Rule. Generally, Code Section 1031 allows exchanges between related parties, subject to certain conditions discussed below.

1. The Statute. Code Section 1031(f)(1) provides the general rule for related party exchanges:

> If—
>
> (A) a taxpayer exchanges property with a related person,
>
> (B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and
>
> (C) before the date 2 years after the date of the last transfer which was part of such exchange—

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

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

2. The Three Conditions. To be disqualified from Code Section 1031 treatment, a related party exchange must satisfy the following three conditions:

a. First, the taxpayer must exchange property with a related person. Code Section 1031(f)(3) provides that the term "related person" means "any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1)." Appendix A attached hereto sets forth a list of those relationships.

b. Second, the initial exchange between the taxpayer and the related person must qualify for nonrecognition treatment under Code Section 1031 (determined without regard to the related party rules).

c. Third, either the taxpayer or the related party must dispose of the property received in the exchange within two years from the date the last transfer that was part of the exchange.

3. If the first two conditions are satisfied, and two or more years pass from the date of the related party exchange, the exchange will no longer be subject to the related party rules, and, thus, subsequent transfers of the exchanged property by either party will not affect the original exchange.[1] However, if the exchanged property is transferred by either party during the first two years, such transfer will invalidate the original exchange. The gain or loss on the invalidated exchange must be recognized at the time the subsequent transfer occurs.

[1] However, under Code Section 1031(g)(1), the running of the two-year holding period set forth in Code Section 1031(f)(1)(C) will be suspended with respect to "any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by—(a) the holding of a put with respect to such property; (b) the holding by another person of a right to acquire such property, or (c) a short sale or any other transaction." I.R.C. § 1031(g)(2). Thus, taxpayers seeking to wait out the two year holding period should avoid entering into a binding purchase and sale agreement for the relinquished or replacement property within the two year period, which could trigger the application of Code Section 1031(g).

B. Exceptions. Certain dispositions are ignored for purposes of determining whether a prohibited disposition has occurred within two years.

1. Code Section 1031(f)(2) provides:

> For purposes of paragraph (1)(C), there shall not be taken into account any disposition—
>
> (A) after the earlier of the death of the taxpayer or the death of the related person,
>
> (B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or
>
> (C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

2. No Principal Purpose of Tax Avoidance. The third prong of the exception above exempts subsequent dispositions where it is established that neither the original exchange nor the subsequent disposition had a principal purpose of tax avoidance. The legislative history of Code Section 1031(f) elaborates on the types of dispositions that lack a principal purpose of tax avoidance. *See* S. Print No. 56, 101st Cong., 1st Sess. 152 (1989). Those dispositions include:

a. Transactions 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 larger undivided interest in any of such properties;

b. Dispositions of property in nonrecognition transactions; and

c. Transactions that do not involve the shifting of basis between parties.

C. Anti-Avoidance Provision. Code Section 1031(f)(4) contains an anti-avoidance provision designed to ensure compliance with the purpose underlying Code Section 1031(f)(1).

1. The Statute. Code Section 1031(f)(4) provides: "This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection."

2. Example. The legislative history gives the following description of a situation considered to fall within the scope of the anti-avoidance provision: "[I]f a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031." *See* H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1341 (1989). The foregoing description is meant to address an end-run around the statute. Taking the previous example set forth in section I.B. of this outline, if B sells Farm to Buyer for $1,000,000 (recognizing no gain or loss because amount realized equals basis), and then within 2 years Buyer and A exchange Farm and Skyscraper pursuant to Code Section 1031, the parties would accomplish the same result that was previously forbidden had A and B exchanged directly, with B then selling Skyscraper to Buyer. Code Section 1031(f)(4) prevents this result.

III. Early Rulings Interpreting Code Section 1031(f)

Certain authorities interpret Code Section 1031(f), particularly whether the anti-avoidance provision and the exception for subsequent dispositions where neither the exchange nor such disposition had as one of its principal purposes the avoidance of tax applies if the taxpayer structures the exchange using a qualified intermediary ("QI"). The applicable authorities are discussed below.

A. TAM 9748006. In TAM 9748006, the IRS ruled that a transfer involving a QI (unrelated to the taxpayer) and a related party was a related party transaction and that the taxpayer had to recognize gain on the transaction. The transaction occurred as follows: (1) the taxpayer transferred Property X to QI, (2) the QI sold Property X to an unrelated third party for cash, (3) the QI used the cash proceeds from the sale of Property X to acquire an interest in Property Z from the taxpayer's mother (a related party), (4) the QI transferred the interest in Property Z to the taxpayer and the taxpayer paid additional cash to his mother to make up for the difference in value between Property Z and Property X, and (5) the taxpayer's mother sold Property Y to the unrelated third party for cash. The IRS ruled that this transaction was in substance a transfer of Property X to the taxpayer's mother in exchange for Property Z, followed by a sale of Property X by the taxpayer's mother to the unrelated third party for cash. As such, the deemed exchange implicated Code Section 1031(f). The IRS also noted that the taxpayer used the QI for the purpose of avoiding the related party rules under Code Section 1031(f), which, under Code Section 1031(f)(4), prohibited the application of Code Section 1031(a)(1) to the transaction.

B. TAM 200126007. The IRS disallowed like kind exchange treatment to the taxpayer in TAM 200126007 under slightly different facts from TAM 9748006. In TAM 200126007, the taxpayer entered into two transactions involving a related party. The taxpayer intended the transactions to qualify for like kind exchange treatment and structured both to occur with the assistance of a QI. In ruling that neither transaction qualified for like kind exchange treatment, the IRS adopted an "economic unit" test. Under that test, the IRS ruled that the related parties were part of a single economic unit and to the extent any portion of the economic unit's investment was cashed out, the exchange did not qualify for like kind exchange treatment. The consequences of the transactions were (1) to shift the taxpayer's low basis in its relinquished property to the replacement property and (2) to reduce the controlled group's investment in real property and to apply amounts realized on the disposition of the relinquished property to reduce the controlled group's outstanding debt. The IRS ruled that this is the type of transaction Code Section 1031(f) was enacted to prevent.

C. FSA 200137003. In FSA 200137003, Partnership and S-Corp were related parties. Partnership owned Blackacre, and S-Corp owned Whiteacre, which were like kind properties. In Year 2, Partnership and S-Corp exchanged Blackacre and Whiteacre. On a date more than two years after the exchange of Blackacre for Whiteacre, Partnership sold Whiteacre.

The IRS ruled that because the subsequent sale of Whiteacre occurred more than two years after the exchange, that Code Section 1031(f)(1) "does not literally apply" and that the two year rule "is a safe harbor that precludes application of Section 1031(f)(1) to any transaction falling outside that period." Thus, according to the IRS, "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." The IRS also ruled that planned dispositions beyond the two year waiting period do not violate Code Section 1031(f)(4): "I.R.C. Section 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. . . . 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."

D. Revenue Ruling 2002-83. Revenue Ruling 2002-83, 2002-49 I.R.B. 927, adds to the related party rules by holding that the use of an unrelated QI by related taxpayers to complete an exchange and sale will be denied like-kind exchange treatment. The facts of the ruling are as follows: A and B are related parties. A owns Property 1 with a fair market value of $150x and an adjusted basis of $50x. B owns Property 2 with a fair market value of $150x and an adjusted basis of $150x. C, an unrelated person, desires to acquire Property 1 from A. To facilitate the transaction, A, B, C and a QI entered into a like kind exchange agreement. Pursuant to the agreement, A transferred Property 1 to the QI, who then transferred Property 1 to C for $150x. Days later, the QI paid the $150x proceeds to B for Property 2, and then transferred Property 2 to A. In the end, C owned Property 1, A held replacement Property 2, and B had cashed out. As in TAM 9748006, the IRS stated that, under Code Section 1031(f)(4), if an unrelated third party is used to circumvent the purposes of the related party rule in Code Section 1031(f), the nonrecognition provisions of Code Section 1031 will not apply to the transaction. The IRS found that A used the QI to circumvent the purposes of Code Section 1031(f) and, thus, held that under Code Section 1031(f)(4) the exchange did not qualify for gain deferral.

Thus, Revenue Ruling 2002-83 stands for the proposition that a taxpayer cannot use a QI to indirectly complete an exchange that the taxpayer could not have completed directly with a related party. If a QI is inserted into the middle of an exchange, the IRS will recast the transaction as if the taxpayer and related party had exchanged directly, followed immediately thereafter by a disposition of the taxpayer's relinquished property by the related party. This subsequent disposition will void the exchange for the taxpayer, unless the taxpayer can prove that the subsequent disposition meets one of the permitted exceptions discussed above.

IV. Rulings Interpreting Who is a Related Party

In order for Code Section 1031(f) to apply, the exchange must involve related parties as defined in Code Section 1031(f)(3). The following rulings address the issue of whether certain parties are related.

A. PLR 200730002. In PLR 200730002, taxpayer proposed to conduct an exchange between himself and a trust for the benefit of his niece (which was formerly for the benefit of his brother, who had died) where taxpayer also was the trustee of such trust. However, the facts recite that prior to the exchange, "Taxpayer will resign as trustee" of the trust. Therefore, the IRS ruled that taxpayer would not be a related party to the trust or niece provided taxpayer "resigns as successor trustee, as provided in the original trust agreement, at or near the time of the exchange." This ruling lends support to the notion that taxpayers may intentionally break related party relationships prior to initiating a 1031 exchange in order to avoid the restrictions of Code Section 1031(f).

B. PLR 200919027. In PLR 200919027, the taxpayer requested a ruling that taxpayer and "Trust C" were not related persons. The rulings describes a situation where taxpayer initially owned a property as tenants-in-common with taxpayer's two siblings B and C. Subsequently, taxpayer, B and C each conveyed their undivided interests in the property to grantor trusts for each of them. Later, sibling C died, and sibling C's spouse and her two children became the trustee's of C's trust. Later, taxpayer, sibling B, and C's trust decided to exchange undivided interests in the property such that each would own a 100% fee interest in discrete properties. The ruling concludes that Code Section 1031(f) would not apply to this exchange because taxpayer and sibling B are not related to the trustee's of C's trust since these are C's spouse and children, which are not relationships described in Code Section 267(c)(4) (defining "family of an individual" to include only the individual's brothers and sisters, spouse, ancestors, and lineal descendants). PLR 200920032 (May 15, 2009) is a virtually identical, companion ruling.

V. Application of the Non-Tax Avoidance Exception

As noted above, dispositions of the replacement property or relinquished property by either the taxpayer or the related party within two years of the initial 1031 exchange will invalidate the transaction. However, under Code Section 1031(f)(2)(C), an exception exists if neither the first disposition or the second disposition had as one of its principal purposes the avoidance of federal income tax, which legislative history interprets to include (i) transactions 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 larger 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 parties. The following rulings interpret the non-tax avoidance exception in various contexts.

A. PLR 200730002. In PLR 200730002, the taxpayer, taxpayer's brother, and a trust for the benefit of taxpayer's deceased brother owned certain farmland as tenants in common. The parties proposed to exchange their undivided interest such that taxpayer would own a fee interest in 1/3 of the entire property by value, and taxpayer's brother and the trust would own the remaining 2/3 of the value still as tenants in common on such portion. Soon thereafter (and within the two year waiting period), the brother and trust intended to sell their shares of the farmland for cash. The IRS ruled that the non-tax avoidance exception, in particular the first prong from the legislative history addressing exchanges of undivided interests, applied so as to not disallow the taxpayer's 1031 exchange. According to the IRS: "In the present case, prior to the disposition [by brother and trust], there will be an exchange of undivided interests in which the exchanging parties receive either a whole interest in property or a larger undivided interest in property. According to the legislative history under § 1031(f), Congress intended that the non-tax avoidance exception of § 1031(f)(2)(C) apply to this specific circumstance . . . . Consequently, the parties in the present case do not have (or are deemed to not have) the intent to avoid the federal income tax by the exchange of their undivided interest and subsequent sale of some of the interests being exchanged within two years."

B. PLR 200706001. In PLR 200706001, the taxpayer's Father, during his lifetime, acquired certain timberlands, which he held for income producing and investment purposes. The parcels at issue in the ruling where Parcel 1, Parcel 2, and Parcel 3. After taxpayer's Father's death, Parcel 1 was transferred to Taxpayer's Mother, and Parcels 2 and 3 were transferred to a Trust for the benefit of taxpayer's Mother. Subsequent to the receipt of Parcel 1, taxpayer's Mother gifted Parcel 1 to taxpayer and her siblings in equal undivided interests as tenants-in-common. Later, the trustees of the Trust and the siblings decided to sell all of their land holdings including Parcels 1, 2 and 3. Taxpayer did not want to divest herself in ownership of real estate, so to accommodate the parties' desires, the parties agreed that taxpayer would exchange her undivided 25% interest in Parcel 1 for a 100% fee simple interest in Parcel 3. The parties agreed that the fair market value of taxpayer's 25% interest in Parcel 1 was equal to the fair market value of Parcel 3. Following the exchange, the Trust and siblings sold Parcels 1 and 2 to an unrelated third party. Taxpayer represented that that the respective per acre basis in Parcels 1 and 3 were equivalent as a result of the step-up in basis which occurred when taxpayer's Father died owning the parcels.

The IRS ruled that neither the exchange nor the subsequent disposition of Parcel 1 was a disposition that caused recognition of gain to taxpayer pursuant to the income recognition rule of Code Section 1031(f) for exchanges between related persons. The IRS relied on the legislative history underlying the non-tax avoidance exception of Code Section 1031(f)(2)(C), which states that dispositions that do not involve the shifting of basis between properties are not taken into account. Because the per acre basis in Parcels 1 and 3 were equivalent as a result of the step-up in basis upon death, under Code Section 1031(f)(2)(c) the transaction did not involve basis shifting and therefore fell within the non-tax avoidance exception.

C. PLR 201834010. In PLR 201834010, the taxpayer and its related party "Affiliate" entered into a direct, simultaneous 1031 exchange where in the taxpayer conveyed certain relinquished property to Affiliate and received two replacement properties – Property 1 and Property 2 – from Affiliate in the exchange. Within two years thereafter, the taxpayer disposed of Property 1 as part of a second 1031 exchange wherein the taxpayer received other replacement property with no boot. In addition, taxpayer contributed Property 2 to a pre-existing partnership (in which taxpayer already was a partner) solely in exchange for an additional interest in such partnership in a non-taxable contribution under Code Section 721(a). The ruling notes that at the time of the initial exchange with Affiliate, taxpayer did not intend, and did not have a prearranged plan, to enter into the subsequent transactions discussed in the ruling.

The IRS ruled that the taxpayer's subsequent dispositions of Property 1 (via a second 1031 exchange) and Property 2 (via a contribution to a partnership under Code Section 721(a)) qualified for the non-tax avoidance exception under Code Section 1031(f)(2)(C). According to the IRS: "Since both dispositions are in nonrecognition transactions and Taxpayer receives neither cash nor other consideration that would trigger gain in the dispositions, the dispositions are, under § 1031(f)(2)(C), ignored in determining whether § 1031(f) applies to require gain recognition in the Initial Exchange."

D. The "Daisy Chain" Rulings. As noted previously, as a general matter, a taxpayer cannot purchase its replacement property from a related party because under Code Section 1031(f)(4), the transaction will be recast as a direct exchange between the taxpayer and related party, followed immediately thereafter by a sale of the exchanged property by the related party, which generally is a violation of Code Section 1031(f) (unless an exception applies). However, the statute provides a key exception for subsequent dispositions where neither the exchange nor subsequent disposition had as a principal purpose the avoidance of federal income tax, which legislative history interprets to include dispositions in nonrecognitions transactions. Per this line of reasoning, the IRS has issued a string of private letter rulings allowing taxpayers to acquire replacement property from a related party, so long as the related party does its own independent back-to-back 1031 exchange into its own replacement property acquired from an unrelated third party (with either no boot or only a de minimis amount of boot). These transactions have been termed "daisy chains" and are useful in allowing groups of related taxpayers additional time (beyond the initial taxpayer's 180-day replacement period) in which to complete a daisy chain and ultimately purchase replacement property from an unrelated party. These rulings are discussed below.

1. PLR 200440002. PLR 200440002 further clarifies and builds upon Revenue Ruling 2002-83. The facts are as follows: AB and CD were related parties per Code Section 1031(f)(3). AB owned building 1, and CD owned building 2. Buyer, an unrelated person, desired to acquire building 1. AB wanted to defer gain recognition on the transfer and therefore proposed the following series of related transactions: First, AB will transfer building 1 to Buyer pursuant to an exchange agreement entered into with QI, a qualified intermediary within the definition of Treas. Reg. § 1.1031(k)-1(g)(4). Because AB will use QI to transfer building 1, QI will be treated as selling building 1 to Buyer. Second, QI will acquire building 2 from CD and transfer it to AB as replacement property. Pursuant to an exchange agreement between CD and QI, QI will be treated as acquiring building 2 from CD and as transferring it to AB. Finally, QI will purchase replacement property from Seller, an unrelated person, and transfer it to CD as replacement property for building 2. Afterwards, Buyer will own building 1, AB will own building 2, CD will own replacement property, and Seller will have cash. AB and CD both represented that neither would dispose of its replacement property within two years of its receipt of such property. The issue was whether Code Section 1031(f) applied.

On the face of the transaction, Code Section 1031(f)(1) was inapplicable, since AB and CD (related persons) never directly exchanged with each other and instead exchanged with QI (an unrelated person). However, according to the IRS, despite use of a QI, Code Section 1031(f)(1) still could apply if Code Section 1031(f)(4) applied, which section prohibits 1031 exchanges that are part of a transaction or series

of transactions structured to avoid the purposes of Code Section 1031(f). Thus the issue became whether Code Section 1031(f)(4) applied. If the QI was used to circumvent the purposes of Code Section 1031(f), then the transaction would not qualify for nonrecognition treatment under Code Section 1031.

Ultimately, the IRS ruled that Code Section 1031(f)(1) did not apply to the exchanges. The decision was based principally on a finding that CD's subsequent disposition (in a Code Section 1031 exchange) qualified under Code Section 1031(f)(2), which section provides that certain dispositions will not be taken into account for purposes of Code Section 1031(f)(1)(C), including a disposition where neither the original exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. The legislative history regarding this non-tax avoidance exception indicates that it would generally apply to dispositions in nonrecognition transactions. *See* S. Print No. 56, 101st Cong., 1st Sess. 152 (1989). According to the IRS:

> In the present case, the only subsequent disposition contemplated by the parties after [AB] receives Building 2 as replacement property is the use of the proceeds from the disposition of Building 2 by [CD] to acquire like-kind replacement property in another exchange under § 1031, a nonrecognition transaction. Thus, because [CD] is structuring its disposition of Building 2 as an exchange for like-kind replacement property so that the gain on the transfer of Building 2 is eligible for nonrecognition treatment under § 1031(a), § 1031(f)(4) and Rev. Rul. 2002-83 are not applicable.

The situation in PLR 200440002 is distinguishable from Revenue Ruling 2002-83. In Revenue Ruling 2002-83, recall that B cashed-out its investment at the end of the day. The IRS looked at the transaction and concluded that A and B could not do indirectly, through a QI, what they could not do directly. In PLR 200440002, the IRS concluded that the parties could do indirectly what they could also do directly. If AB and CD had first exchanged buildings 1 and 2 with each other, with CD then transferring building 2 to Buyer through QI in exchange for replacement property from Seller, CD's subsequent disposition would have fallen into the exception provided by Code Section 1031(f)(2)(C). The fundamental difference is that in Revenue Ruling 2002-83, B cashed-out its investment, whereas in PLR 200440002, CD did not cash-out

2. PLR 200616005. PLR 200616005 is very similar to PLR 200440002, and the IRS reached the same conclusions. Notably, both parties represented that each would hold their respective replacement properties received for more than two years from the applicable acquisition date of each such property, as opposed to the two years running from the last date of acquisition.

3. PLR 200810016. In PLR 200810016, AB LLC owned Blackacre and related party CD LLC owned Greenacre. AB desired to sell Blackacre to a third party and then use the proceeds (via a QI) to acquire Greenacre as replacement property in a 1031 exchange. CD then would use its proceeds (via a QI) to acquire its on replacement property from an unrelated third party in a back-to-back 1031 exchange. The parties represented that AB would not dispose of Greenacre, and CD would not dispose of its replacement property, within two years of AB's receipt of Greenacre or CD's receipt of its replacement property, "whichever is later". The ruling does mention that neither party planned to cash out its investment, "other than some possible boot" but does not discuss the amount of potential boot.

The IRS upheld the validity of the transaction, finding that neither Code Section 1031(f)(1) nor 1031(f)(4) would apply (for the same reasons consistent with prior, similar rulings). According to the IRS: "[T]he only subsequent disposition of replacement property contemplated by the parties is the use of the proceeds from the disposition of Greenacre by CD LLC to acquire CD LLC's replacement property in another exchange under § 1031, a nonrecognition transaction. Therefore, § 1031(f)(4) will not apply to

require recognition of gain or loss in the exchanges of either party. . . . There is no 'cashing out' of either party's investment in real estate."

4. PLR 200820017. In PLR 200820017, the taxpayer sold relinquished property (RQ), deposited the proceeds with a QI, and used the proceeds (through the QI) to acquire certain replacement property (RP) from its related party in a 1031 exchange. In turn, the related party deposited these funds with its own QI and caused the QI to use such funds to acquire replacement property from an unrelated third party and then transfer same to the related party in its own back-to-back 1031 exchange. The ruling also states that the related party would likely receive some cash boot in its separate 1031 exchange, but not in excess of __% (the precise percentage is redacted), and that neither the taxpayer nor the related party would dispose of their respective replacement properties before two years from the later acquisition of the respective replacement properties.

The IRS ruled that Code Section 1031(f)(1) did not apply to the taxpayer's exchange of RQ for RP because the Taxpayer was deemed to have exchanged property with its QI, who is not a related person. The IRS also ruled that Code Section 1031(f)(4) did not apply to void the taxpayer's exchange because the non-tax avoidance exception of Code Section 1031(f)(2)(C) is subsumed within the analysis under Code Section 1031(f)(4), and under legislative history, one of the applicable exceptions is for "dispositions of property in nonrecognition transactions," and that here, the related party's disposition of RP to taxpayer was pursuant to the related party's own independent 1031 exchange, which was a nonrecognition transaction that met the exception. According to the IRS: "Because [related party] is also structuring its disposition of [RP] as an exchange for like-kind replacement property, neither § 1031(f)(4) nor Rev. Rul. 2002-83 applies. . . . There is no 'cashing out' of either party's investment in real estate." The IRS did note that the related party would retain a "limited amount of boot" in the exchange, not in an amount greater than __%, but that such amount was not sufficient to invalidate taxpayer's 1031 exchange. Unfortunately, the ruling does not detail the amount of boot allowable, but subsequent daisy chain rulings have expressly stated that allowable boot could not exceed 5% of the gain realized.

5. PLR 200820025. PLR 200820025 is generally the same as PLR 200820017. The amount of allowable boot also was redacted in this ruling.

6. PLR 201048025. PLR 201048025 is generally the same as PLR 200820017, and the amount of allowable boot also was redacted. However, a key difference in this ruling is that the taxpayer acquired its replacement property from related party #1, who then acquired its replacement property from related party #2, who then acquired its replacement property from an unrelated third party. Thus, the IRS expanded the daisy chain concept to allow three related taxpayers in the chain. Also, the parties each represented that each would hold its respective replacement property for at least two years following the applicable date of acquisition, as opposed to the two years running from the last date of acquisition as in PLR 200820017. In addition, both the first and second related parties were allowed to retain "X%" amount of boot in their respective exchanges, which the IRS stated to be not "material" and of a "de minimis amount".

7. PLR 201216007. PLR 201216007 is very similar to PLR 201048025 in the sense that it also involved a daisy chain of 3 related parties. A key difference here is that the amount of allowable boot to be received by the related party was expressly stated to be no more than 5% of the gain realized by the related party. Also, the parties represented that all 3 parties would hold their replacement properties for at least two years "after the date of the last transfer of property in the series of exchanges".

8. PLR 201220012. PLR 201220012 is very similar to PLR 201216007. However, the IRS also issued certain additional rulings to the taxpayers that (i) each of the three parties involved had a separate exchange with separate identification and replacement periods and (ii) each separate transfer of

relinquished property each such party in its separate exchange resulted in separate application of the limits on identification of multiple or alternative replacement properties (i.e., separate application of the 3-property and 200% rules).

9. PLR 202053007. PLR 202053007 involves the longest daisy chain transaction to have received a ruling through the date of this outline. In the ruling, taxpayer was a corporation and was a "related person" (as defined in Code Section 1031(f)(3)) to Company 1 and Company 2. The ruling also states that Company 1 and Company 2 were related persons to each other and to Company 3 and Company 4 (which also were related persons to each other). The ruling does not describe the nature of these relationships, but summarily concludes that the parties were related.

The ruling states that taxpayer engaged in a 1031 exchange by selling relinquished property to a third party via a QI, and using the proceeds to acquire replacement property from Company 1 and Company 2 (both related parties to taxpayer). Taxpayer did not receive any cash boot in this exchange. Company 1 in turn completed its own 1031 exchange (via a QI) from this transfer to taxpayer and acquired replacement property from an unrelated party. Company 1 received no cash boot. Company 2 likewise completed its own 1031 exchange (via a QI) from this transfer to taxpayer and acquired replacement property from Company 3, a related person to Company 2. Company 2 received no cash boot. Company 3 likewise completed its own 1031 exchange (via a QI) from this transfer to Company 2 and acquired replacement property from Company 4, a related person to Company 3. Company 3 received no cash boot. Company 4 likewise completed its own 1031 exchange (via a QI) from this transfer to Company 3 and acquired replacement property from an unrelated party. Company 4 received no cash boot. Thus, the "daisy chain" was from taxpayer to Company 2 to Company 3 to Company 4 to an unrelated party. No boot was received at any point along the chain. Taxpayer represented that all of the entities would continue to own the property received in its exchange for at least two years after the date of the last transfer in the series.

As in prior rulings, the IRS ruled that Code Section 1031(f)(1) did not apply because taxpayer's exchange was with the QI, not with a related party. Moreover, Code Section 1031(f)(4) did not apply due to the exception for non-tax avoidance transactions involving subsequent dispositions in nonrecognition transactions. Specifically, all of the entities across the chain of exchanges completed 1031 exchanges in full with no boot, so each of the related parties remained invested in like kind replacement property at the end of the series of transactions, with no cashing out by any of the related entities.

VI. Built-to-Suit Transactions with Related Parties

A series of PLRs allow taxpayers to structure build-to-suit 1031 exchange transactions by constructing new improvements on land owned by a related party, provided the related party enters into a long term lease (or sublease) of the land as opposed to selling the property outright. These rulings are summarized below:

A. PLR 200251008. PLR 200251008 endorses a build-to-suit exchange transaction between a taxpayer and a related party. In the ruling, the taxpayer owned improved property ("RQ") and desired to swap it for a 32-year sublease of land with improvements to be made thereon ("RP"). The 32-year sublease was held by LLCW, a related person. In its simplest version, the exchange was structured as follows: (1) Taxpayer entered into valid exchange agreements with an exchange accommodation titleholder ("EAT") and a QI; (2) LLCW sub-subleased RP, at fair market rent, to EAT's wholly owned LLC ("Titleholder") for a term of 32 years; (3) Titleholder constructed improvements on RP; (4) Taxpayer sold RQ to an unrelated buyer through the QI; (5) The QI used the sales proceeds from RQ to purchase Titleholder (who held the 32-year sub-sublease of the newly-improved RP) from EAT; (6) The QI transferred Titleholder to the taxpayer. The IRS upheld the validity of the like kind exchange. Crucial to this decision was a finding that the related party (LLCW) had not cashed out its investment in RP. By subleasing RP for fair market

rent to Titleholder and thus to the taxpayer, LLCW never cashed-out its investment in RP. The IRS noted the importance of this fact, stating "[s]ince 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 is part of the exchange." *Id.*

B. PLR 200329021. PLR 200329021 involved a taxpayer who was the wholly-owned subsidiary of Parent. Parent had entered into a long-term lease (a 20-year initial period with four five-year renewal options) before the date the taxpayer contemplated disposing of its property (RQ) as part of a Section 1031 exchange. To complete the exchange, taxpayer desired to use the RQ proceeds to construct improvements on the property leased to Parent. The steps of the exchange were as follows: (1) To structure the transaction as a qualified exchange accommodation arrangement under Rev. Proc. 2000-37, Parent assigned the leasehold to an LLC wholly-owned by an EAT. At the time of the assignment, the leased property was unimproved, except for demolition of the existing building on the site and rough grading (all performed by the landlord). At the time Parent assigned the lease to LLC, Parent also invoiced LLC for soft costs (*i.e.* engineering, surveys, etc.) associated with the LLC's construction of the improvements. Parent did not, however, invoice LLC for other costs incurred to enter into the lease. (2) Under Parent's direction, LLC constructed improvements. The taxpayer disposed of RQ with the proceeds going to a QI. Those proceeds were then advanced to LLC to fund construction of the improvements. LLC first used a portion of its first advance from the QI to reimburse Parent for the invoiced costs. It also paid the construction contractor for the costs of construction from the advances from the QI. (3) Before the earlier of the date that was 180 days after Parent assigned the leasehold to LLC and the date that was 180 days after the taxpayer transferred RQ, the LLC assigned the leasehold with improvements to the taxpayer.

The IRS ruled that to the extent the improvements were complete when the leasehold was assigned to the taxpayer, the transaction qualified as a good 1031 exchange. In addition, the IRS ruled that, despite the fact that the taxpayer and Parent were related, since both the taxpayer and Parent "continue to be invested in exchange properties, both will remain so invested for a period of not less than two years following the exchange, and neither is otherwise cashing out its interests, gain recognition is not triggered under §1031(f)(4)." Thus the IRS endorsed the use of a lease assignment (in lieu of a sublease) by a related party to an EAT in a related party build-to-suit exchange transaction.

C. PLR 201408019. In PLR 201408019, taxpayer was a partnership and indirect subsidiary of a REIT (through the REIT's TRS and OP). Taxpayer proposed to sell relinquished property to an unrelated party, and to use the proceeds in a 1031 exchange to acquire new improvements on a ground lease owned by taxpayer's related party (the OP). As an initial step, the OP, through a disregarded entity, demolished a building located on its ground lease interest, and then subleased (for a term in excess of 30 years) the vacant land to an EAT engaged by taxpayer at a fair rental value. Thereafter, and during the 180-day parking period, taxpayer advanced funds to EAT which EAT used to fund the construction of new real property improvements on the vacant land. Taxpayer represented that neither taxpayer nor the OP (acting through its disregarded entity) would dispose of either of their interests within the two years after the last transfer that was part of the exchange.

The IRS ruled that the taxpayer exchanged a fee interest in improved real estate for a long-term lease of a tract of land for a period in excess of 30 years and improvements thereon, and accordingly, the transaction was a valid 1031 exchange. Further, the IRS ruled that Code Sections 1031(f)(1) and 1031(f)(4) did not apply to disqualify the transaction because the taxpayer did not exchange directly with the related party, and also there will be no cashing out by the related party within two years of the last transfer of the series of transactions (due to the sublease at fair rental value). In addition, the IRS ruled that Rev. Proc. 2004-51 did not apply because the replacement property held by the EAT had never been owned by the taxpayer.

D. PLR 202520001. PLR 202520001 is similar to PLR 201408019 except, the taxpayer at issue initially owned the land to be developed, and the related party was a captive partnership owned by the taxpayer directly and indirectly via a TRS also owned by the same taxpayer. As a preliminary step, the taxpayer contributed the land to its captive partnership subsidiary more than 180 days prior to the ground lease to the EAT. The ruling alluded to the taxpayer's business purpose, stating as a fact that the "contribution of Land to Partnership will separate the Partnership's ground-leasing business and other real estate operations in specific geographic territories from Taxpayer's other real estate business operations." The IRS ruled that Code Sections 1031(f)(1) and 1031(f)(4) did not apply to void the taxpayer's 1031 exchange because the related party remained invested in the fee interest in the land. The IRS also ruled that Rev. Proc. 2004-51 did not apply since the related party owned the land for more than 180 days prior to the lease to the EAT. The IRS did state that the taxpayer may recognize some boot in its exchange due to "failure of contractors to timely complete improvements."

VII. Concurrent QEAAs

The IRS has expressly endorsed situations where related parties enter into concurrent QEAAs for the same parked replacement property with the same EAT in situations where the related parties, as a group, desire to acquire the parked property in a 1031 exchange, but are uncertain as to which of the related parties will be able to sell a relinquished property first that best matches up with the parked replacement property. Use of concurrent QEAAs in this situation provides greater flexibility to the related parties to be able to sell a relinquished property to match with the parked replacement property.

A. PLR 201242003. Taxpayer and its related party "Affiliate" each owned separate multifamily properties that each may potentially transfer in a 1031 exchange. Each entity targeted a specific "Property" for acquisition as replacement property in a 1031 exchange. The seller of the subject Property required that the closing of the sale to occur by a specific date, but neither Taxpayer nor Affiliate had disposed of any relinquished property by such date. Therefore, both Taxpayer and Affiliate initiated a reverse 1031 exchange under Rev. Proc. 2000-37 by entering into a QEAA (one for each party) with an EAT. Each QEAA provided that the EAT would park title to the Property on behalf of either Taxpayer or Affiliate, as applicable, and also acknowledged the concurrent QEAA for the Property in existence for the other party. The QEAAs also provided that the first party to give notice to EAT of its intention to acquire the Property would have the right to acquire the Property from the EAT, which would then terminate the rights of the other party to acquire the Property under such party's QEAA. However, if one party stated an intention to only acquire a portion of the parked Property, the other party would retain its rights to acquire the balance of the parked Property in such party's separate 1031 exchange.

The purpose for the concurrent QEAAs, according to the IRS was that at the time the EAT took title to the subject Property, "it was not clear whether Taxpayer or Affiliate, each of which had identified relinquished properties, would complete the transfer of one or more such identified properties to complete the exchange within the 180-day period permitted for a QEAA under Rev. Proc. 2000-37." The IRS upheld the validity of the concurrent QEAA arrangement, finding that an EAT "may enter into QEAAs with more than one entity, including persons related to Taxpayer, each of which has a bona fide intent to acquire the same property as the replacement property for their respective exchanges. Rev. Proc. 2000-37 . . . does not prohibit an accommodation party from serving as EAT to multiple taxpayers under multiple and simultaneous QEAAs for the same parked property."

B. PLR 201416006. This ruling is almost identical to PLR 201242003, except it involved 3 related parties instead of 2 related parties.

VIII. Sales of Relinquished Property to Related Parties

The following rulings describe situations where taxpayers, to initiate 1031 exchanges, have sold relinquished property to a related party for cash, which the taxpayer directs to a 1031 exchange account with a QI, and which the taxpayer then uses to acquire replacement property from an unrelated third party. These rulings all allow the 1031 exchanges on the grounds that Code Section 1031(f) is not applicable because there was never an exchange between the taxpayer and its related party since the related party did not own any replacement property that the taxpayer ultimately acquired. These rulings are particularly helpful to taxpayers who have parked replacement property with an EAT and are having difficulty selling relinquished property to a third party by the 180-day deadline prescribed by Rev. Proc. 2000-37. In this situation, sometimes the taxpayer can save the reverse exchange by triggering a sale of relinquished property to a related party, and then use such proceeds in a forward exchange to acquire the parked replacement property.

A. PLR 200709036. In PLR 200709036, the taxpayer held certain rental real property for more than two years, and later sold such property to a related party for its fair market value to initiate a forward 1031 exchange. Taxpayer then acquired replacement property from an unrelated party within the 180 day exchange period. The taxpayer represented that its related party (as purchaser of the relinquished property) anticipated selling some or all of such property within two years from the date of its acquisition. The ruling does not state a specific business purpose for the sale of the relinquished property to the related party.

The IRS ruled that Code Section 1031(f)(1) was not applicable to the transaction because the taxpayer's exchange was between the taxpayer and the QI, who was not a related person. The IRS also ruled that Code Section 1031(f)(4) was not applicable because the taxpayer and its related party did not exchange properties either directly or through the QI, since the related party did not own, prior to the exchange, the replacement property that taxpayer acquired in the exchange. Thus, the IRS found that there was no transaction, or series of transactions structured to avoid the purposes of Code Section 1031(f) within the meaning of Code Section 1031(f)(4). Finally, the IRS ruled that because Code Sections 1031(f)(1) and (f)(4) were not applicable, the prohibition in Code Section 1031(f)(1)(C) against dispositions of the relinquished property or the replacement property within two years of acquisition did not apply.

B. PLR 200712013. PLR 200712013 is very similar to PLR 200709036, except the exchange was structured as a reverse exchange instead of a forward exchange. Thus, taxpayer first parked a replacement property with an EAT, and as a second step, sold relinquished property to its related party and then used the cash proceeds (via a QI) to acquire the parked replacement property in a 1031 exchange. Notably, the taxpayer also represented that the related party intended to dispose of the purchased relinquished property within two years of its acquisition. The IRS ruled that Code Section 1031(f) was not applicable since there was not an exchange of properties between related parties.

C. PLR 200728008. PLR 200728008 is very similar to PLR 200709036 and PLR 200712013. It involved two separate 1031 exchanges, one structured as a reverse exchange and the other structured as a forward exchange. In both exchanges, the taxpayer sold relinquished property to a related party for its fair market value, and then used the proceeds to acquire replacement properties (one forward exchange, one reverse exchange) from unrelated parties. As in the prior rulings, the taxpayer also represented that the related party intended to dispose of the purchased relinquished properties within two years of their acquisition

D. PLR 201027036. PLR 201027036 is very similar to PLR 200709036, except that the ruling states a business purpose for the taxpayer's sale of the relinquished property to the related party: "[Related party] acquires [relinquished property] by purchase or consignment, disassembles [relinquished property],

and sells the reconditioned parts from it warehouse in Location B. . . . Taxpayer anticipates that most of the parts will be sold to a third party or parties not related to [related party]."

IX. Subsequent Dispositions

Recall that Code Section 1031(f)(1) is triggered only if the taxpayer or the related party disposes of the property received in the exchange within the two year period. In PLR 200541037, taxpayer was an individual who owned certain timberlands held for investment. Taxpayer's son owned all shares of voting stock in "M Corp" and taxpayer and her son together owned all of the non-voting stock in M Corp (although the ruling does not specify this ownership ratio). The ruling states as a fact that because "all shares of the voting common and most shares of the nonvoting common [in M Corp] are owned by Taxpayer or by her 'family' (as that term is defined in § 267(c)(4)), either directly or by attribution pursuant to § 267(c)(2), Taxpayer is considered the owner of more than 50 percent of the value of the outstanding stock of M Corp. Therefore, M Corp and Taxpayer are related persons pursuant to §§ 267(b) and 1031(f)(3)." M Corp also owned certain timberlands in its trade or business of owning and managing timberlands and harvesting timber.

Taxpayer desired to hold timberlands strictly as an investment, while M Corp desired to harvest old-growth timber in its trade or business before the timber loses its value. To accommodate these interests, taxpayer and M Corp proposed to enter into a 1031 exchange whereby taxpayer would convey a 100% interest in old-growth timberland to M Corp in exchange for M Corp's 100% interest in reproduction timberlands of equal value. The exchange would allow taxpayer to accommodate the business needs of M Corp (to harvest timber) while continuing to allow taxpayer to hold timberlands for investment. As part of this plan, within two years of the exchange, M Corp intended to cut and sell the old-growth timber received in the exchange from taxpayer.

The ruling states as a fact that taxpayer and M Corp were related parties because taxpayer owned more than 50% of the stock in M Corp directly and through attribution of taxpayer's son's stock ownership in M Corp. Thus, the ruling expressly applies the attribution rules of Code Section 267(c)(2) to find a related party relationship. In addition, the IRS ruled that the subsequent cutting and sale of old-growth timber by M Corp was not a prohibited disposition that would trigger Code Section 1031(f)(1): "A disposition of the property exchanged between related persons within 2 years will cause recognition of gain under § 1031(f)(1). Under Rev. Rul. 2001-50, the cutting of timber is not a disposition that causes recognition of built-in gains. In the instant case, after the cutting and disposition of the timber, M Corp will still own the underlying land that was exchanged in the proposed transaction. Accordingly, the planned cutting of the timber by M Corp will not trigger recognition of gain under § 1031(f) regardless of whether § 631(a) or (b) applies to the transaction."

X. Caselaw Interpreting Code Section 1031(f)(4)

Shortly after Revenue Ruling 2002-83, courts released a series of decisions interpreting Code Section 1031(f), all of which went against the taxpayers. These cases are discussed below.

A. Teruya Brothers, Ltd. & Subsidiaries v. Commissioner. *Teruya Brothers, Ltd. & Subsidiaries v. Commissioner*,[2] involved two deferred like-kind exchanges among related parties, a QI and unrelated third parties.

1. The simplified facts of *Teruya Brothers* are as follows:

[2] 124 T.C. 45 (2005).

a. Teruya Brothers, Ltd. ("Taxpayer") was a Hawaii corporation. During 1996 the Taxpayer owned 62.5% of Times Super Market, Ltd. ("Times"). As a result, Taxpayer and Times were related parties under Code Section 267(b). Taxpayer proposed entering into two different like-kind exchange transactions. In the first ("Transaction 1"), Taxpayer proposed exchanging, through a QI, the "Ocean Vista" property for replacement property ("Replacement Property 1") held by Times. Ocean Vista was valued at $1,468,500 and Taxpayer's adjusted basis in Ocean Vista was $93,270 (for a built-in-gain of $1,375,230 before expenses). According to the plan, Taxpayer transferred Ocean Vista to the QI, which then sold Ocean Vista to a third party for $1,468,500 cash. The QI then used the cash (along with additional cash contributed by Taxpayer) to purchase Replacement Property 1 from Times. Afterwards, the QI transferred Replacement Property 1 to Taxpayer to complete the exchange. Times's built-in-gain in Replacement Property 1 was $1,352,639.

b. In the second transaction ("Transaction 2"), Taxpayer proposed exchanging, through a QI, the "Royal Towers" property for replacement property ("Replacement Property 2") held by Times. Royal Towers was valued at $11,932,000 and Taxpayer's adjusted basis in Royal Towers was $670,506 (for a built-in-gain of $11,261,494 before expenses). According to the plan, Taxpayer transferred Royal Towers to the QI, which then sold Royal Towers to a third party for $11,261,494 cash. The QI then used the cash (along with additional cash contributed by Taxpayer) to purchase Replacement Property 2 from Times. Afterwards, the QI transferred Replacement Property 2 to Taxpayer to complete the exchange. Replacement Property 2 actually consisted of two separate properties, one of which had a built-in-gain of $2,227,040 and the other of which had a built-in-loss of $6,453,372.

2. The issues for consideration were (1) whether the two transactions were exchanges structured to avoid the purposes of Code Section 1031(f) and, if so, (2) whether Transaction 1 qualified for the exception for transactions not having a principal purpose of avoiding federal income tax.

3. Because the transactions did not involve direct exchanges between related parties (since the QI was interposed), the IRS did not argue that Code Section 1031(f)(1) directly applied. Instead, the IRS argued that Code Section 1031(f)(4), which states that "[t]his section [1031] shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection [(f)]," applied. The court began its inquiry under Code Section 1031(f)(4) by noting that the purpose of Code Section 1031(f)(4) was to prevent related persons from circumventing the application of Code Section 1031(f)(1) by using an unrelated third party to do indirectly what they could not do directly. In addition, the court noted that the non-tax avoidance exception of Code Section 1031(f)(2)(C) must be considered in conjunction with any inquiry under Code Section 1031(f)(4): "Because this exception [under Section 1031(f)(2)(C)] is subsumed within the purposes of section 1031(f), any inquiry into whether a transaction is structured to avoid the purposes of section 1031(f) should also take this exception into consideration." *Id*.

4. Turning to whether Code Section 1031(f)(4) applied, the court found that the Taxpayer's two transactions were "economically equivalent to direct exchanges of properties between [Taxpayer] and Times (with boot from [Taxpayer] to Times), followed by Times's sales of the properties to unrelated third parties" and that "the interposition of [QI] in these transactions [could not] obscure the end result." *Id*. Because Taxpayer offered no explanation for structuring the exchange transactions the way that it did, the court concluded that Taxpayer "used the multiparty structures to avoid the consequences of economically equivalent direct exchanges with Times" and that Code Section 1031(f)(4) would apply unless the exception of Code Section 1031(f)(2)(C) applied. *Id*.

5. With respect to the Ocean Vista transaction, Taxpayer argued that there was no tax avoidance purpose because Times recognized a gain on its sale of Replacement Property 1 ($1,352,639) that was larger than the gain Taxpayer would have recognized ($1,345,169, after deduction of certain selling expenses) had Taxpayer sold Ocean Vista directly for cash. However, the court disagreed:

> Although Times recognized a gain in the Ocean Vista transaction that slightly exceeded Teruya's gain deferral, it appears that Times paid a much smaller tax price for that gain recognition than Teruya would have paid if it had recognized gain in a direct sale of Ocean Vista. On its corporate income tax return for taxable year ending March 31, 1996, Teruya reported taxable income of $2,060,806. Consequently, if Teruya had made a direct sale of Ocean Vista, the gain recognized on that sale presumably would have been taxable at a 34-percent corporate income tax rate. See sec. 11(b)(1)(C). By comparison, on its Form 1120 for its taxable year ending April 25, 1996, Times reported a net operating loss (NOL) of $1,043,829. Thus, although Times recognized a considerable gain on the Ocean Vista transaction, because of offsetting expenses, it did not incur tax on that gain. Instead, the only tax consequences of Times's gain recognition were reductions of its NOL for its taxable year ending April 25, 1996, and of its NOL carryovers for subsequent taxable years. *Id*.

6. Accordingly, the court held that the Taxpayer failed to prove that tax avoidance was not one of its principal purposes for structuring the transactions the way that it did, and thus the transactions failed to qualify for like-kind exchange treatment by reason of Code Section 1031(f)(4).

7. Ultimately, the 9th Circuit[3] affirmed the Tax Court's decision, finding as follows:

> Indeed, as Teruya could have achieved the same property dispositions through far simpler means, it appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f). Teruya could have exchanged its properties directly with Times, followed by Times selling Ocean Vista and Royal Towers to the third-party purchasers. There was no need to use (and pay) a qualified intermediary. The rub, of course, is that Teruya couldn't have done this tax free, as direct exchanges between related parties are ineligible for nonrecognition treatment when the exchanged property is sold within two years. Instead, Teruya employed [the QI], whose presence ensured that Teruya was technically exchanging properties with the qualified intermediary, not with its related party. [The QI's] involvement in these transactions thus served no purpose besides rendering simple – but tax disadvantageous – transactions more complex in order to avoid § 1031(f)'s restrictions.[4]

B. Ocmulgee Fields, Inc. v. Commissioner. In *Ocmulgee Fields, Inc. v. Commissioner*,[5] the taxpayer sold relinquished property called "Wesleyan Station" to an unrelated third party at a gross purchase price of $7,250,000, and directed the net proceeds into a QI account for use in a 1031 exchange. Six days later, taxpayer entered into a PSA with its related party for the purchase of the "Barnes & Noble Corner" as replacement property in taxpayer's 1031 exchange at a gross purchase price of $6,740,900. Within the 45-day identification period, taxpayer closed the acquisition of the Barnes & Noble Corner from its related party to complete a purported 1031 exchange in full. Of key importance, taxpayer's basis in Wesleyan

[3] 580 F.3d 1038 (9th Cir. 2009).

[4] *Id*.

[5] 132 T.C. 105 (2009).

Station was $716,164, resulting in a built-in gain of $6,122,736, while the related party's basis in the Barnes & Noble Corner was $2,554,901, resulting in built-in gain of $4,185,999.

1. The Tax Court, as in *Teruya Brothers*, found that under Code Section 1031(f)(4), the transaction was part of a transaction or series of transactions structured to avoid the purposes of the rules found in Code Section 1031(f)(1), and therefore that the transaction must be viewed and recast as a direct exchange of Wesleyan Station for the Barnes & Noble Corner, followed immediately thereafter by a sale of Wesleyan Station to the actual buyer by the related party. Viewed in this manner, the Tax Court found that the parties violated Code Section 1031(f)(1). Moreover, the Tax Court found that the parties were able to achieve basis shifting due to the related party's higher basis in the Barnes & Noble Corner, and so the exception for non-tax avoidance transactions did not apply. In addition, the Tax Court found that the taxpayer (a corporation subject to a 34% rate) was subject to a higher tax rate than its related party (a partnership whose partners would pay tax at a 15% rate on long-term capital gains), which further compounded the tax savings inherent in the structure whereby the related parties, acting together, would be able to achieve both a lower taxable gain and a lower tax rate by shifting the taxable sale to the related party (as opposed to a direct sale by the taxpayer). According to the Tax Court:

> We are not prepared to say that, as a matter of law, a finding of basis shifting precludes the absence of a principal purpose of tax avoidance, but, in this case, the immediate tax consequences resulting from petitioner's deemed exchange with [related party] included an approximately $1.8 million reduction in taxable gain and the substitution of a 15-percent tax rate for a 34-percent tax rate. The tax savings are plain, and petitioner's counterfactors are unconvincing or speculative. Petitioner has failed to convince us that tax avoidance was not a principal purpose of the deemed exchange.[6]

2. The Eleventh Circuit affirmed the decision of the Tax Court:[7]

> Thus, the substantive result of Ocmulgee Fields' series of transactions supports an inference that Ocmulgee Fields structured its transactions to avoid the purposes of § 1031(f): it was the economic equivalent of a direct related-party exchange for which § 1031(f)(1) would disallow nonrecognition treatment.[8]

C. The Malulani Group, Ltd. and Subs v. Commissioner. In *The Malulani Group, Ltd. and Subs v. Comm'r*,[9] the taxpayer was a Hawaii-based corporation in the business of leasing commercial real estate. The taxpayer disposed of relinquished property located in Maryland (having a built-in gain of$1,888,040), deposited the net exchange proceeds with a QI, and subsequently used those funds to acquire replacement property located in Hawaii that was owned by a wholly-owned subsidiary of the taxpayer (i.e., a related party). The related party recognized gain of $3,127,004, but was able to fully offset this gain with NOLs. The Tax Court denied the Section 1031 exchange on the grounds that the transaction violated the related party rules of Section 1031(f)(4), and the 9th Circuit has affirmed.

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[6] *Id*.

[7] 613 F.3d 1360 (11th Cir. 2010).

[8] *Id*.

[9] T.C. Memo. 2016-209, *aff'd*, 123 A.F.T.R.2d 2019-2190 (9th Cir. 2019).

1. The transaction at issue was similar to those involved in *Teruya Brothers* and *Ocmulgee Fields*, and in *Malulani*, the Tax Court found that the transaction and end result was substantially the same. Thus, in effect, the taxpayer cashed out the investment in the Maryland property with the related party retaining the cash proceeds. The Tax Court rejected two taxpayer arguments as to why its exchange should qualify for the "non-tax-avoidance" exception in Section 1031(f)(2)(C). First, the Tax Court deemed the taxpayer's bona fide, but failed, effort to purchase replacement property from an unrelated party as irrelevant for Section 1031(f)(2)(C) purposes. Second, the Tax Court found the taxpayer's argument that the related party had a relatively low tax basis (and higher relative gain) in the Hawaii property also not relevant for Section 1031(f)(2)(C) purposes. Although Congress enacted Section 1031(f) to limit the exchange of high basis property with low basis property in order to reduce recognition of gain upon subsequent sale, the Tax Court denied the taxpayer's argument in part because the related party seller had NOLs in excess of its recognized gain.

2. In a brief opinion, the 9th Circuit affirmed the Tax Court, reasoning as follows:

> Rather than engaging in the intricate like kind exchanges that achieved favorable tax consequences for Malulani and [its subsidiary,] Malulani could have simply consummated the sales itself. Had it done so, Malulani would have had to recognize a $1,888,040 gain. Because the aggregate tax liability arising out of the exchange was significantly less than the hypothetical tax liability that would have arisen from a direct sale between the related parties, the like kind exchange serviced tax-avoidance purposes. Therefore, Malulani was not entitled to nonrecognition of gain under § 1031.

D. In sum, *Teruya Bros.*, *Ocmulgee Fields* and now *Malulani* continue to stand for the proposition that the IRS will scrutinize 1031 exchanges involving related parties, and transactions are at risk where a taxpayer sells relinquished property and acquires replacement property from a related party in a taxable transaction.

Appendix A

Related parties include:

1. Members of a family (which includes siblings, a spouse, ancestors and lineal descendants) (*See* Code Sections 267(b)(1) and (c)(4));

2. An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual (*See* Code Section 267(b)(2));

3. Two corporations which are members of the same controlled group (*See* Code Section 267(b)(3));

4. A grantor and fiduciary of any trust (*See* Code Section 267(b)(4));

5. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts (*See* Code Section 267(b)(5));

6. A fiduciary of a trust and a beneficiary of such trust (*See* Code Section 267(b)(6));

7. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts (*See* Code Section 267(b)(7));

8. A fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust (*See* Code Section 267(b)(8));

9. A person and an organization to which Code Section 501 applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual (*See* Code Section 267(b)(9));

10. A corporation and a partnership if the same person or persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or the profits interest, in the partnership (*See* Code Section 267(b)(10));

11. Two S corporation if the same person or persons own more than 50 percent in value of the outstanding stock of each S corporation (*See* Code Section 267(b)(11));

12. An S corporation and a C corporation if the same person or persons own more than 50% in value of the outstanding stock of each corporation (*See* Code Section 267(b)(12));

13. An executor of an estate and a beneficiary of the estate (*See* Code Section 267(b)(13));

14. A partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership (*See* Code Section 707(b)(1)(A); and

15. Two partnerships in which the same person or persons own, directly or indirectly, more than 50% of the capital interests or profits interests (*See* Code Section 707(b)(1)(B)).