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A word of caution on like-kind exchanges

October 29, 2009 - Front Section

A recent decision by the Ninth Circuit Court of Appeals should serve as a reminder that caution should be taken when entering in to like-kind exchanges with related parties. In Teruya Brothers Ltd. v. Commissioner, the Court of Appeals confirmed that the IRS could use the rarely cited Section 1031(f)(4) general anti-abuse rules to deny the taxpayer Section 1031 tax deferral. Endorsing the conclusion of the Tax Court, the Court of Appeals determined that an exchange between related parties, interposing a qualified intermediary between the related parties, was an exchange which was part of a transaction structured to avoid gain recognition.

The case involved two separate, but practically identical, exchanges by a corporation. Each of the two exchanges substantially took place as follows. Taxpayer entered into an exchange agreement for the relinquished property with qualified intermediary. Taxpayer transferred the relinquished property to qualified intermediary. At that time, taxpayer had a low basis in the relinquished property. Qualified intermediary used the proceeds from the sale of the relinquished property, plus additional cash from the taxpayer, to acquire the replacement property from the taxpayer's 62.5% owned subsidiary. Later, qualified intermediary transferred the replacement property to the taxpayer as replacement property. In both exchanges, subsidiary recognized a gain on the sale of the replacement property; however, in each case, the gain was sheltered by the subsidiary's net operating losses.

The taxpayer's argument was that the 1031 rules prohibited deferral only in situations where (i) the taxpayer failed to continue its investment in property that it received in the exchange and (ii) the ultimate recipient of the taxpayer's relinquished property was not significant. Here, the taxpayer did continue to hold the replacement property. The court found this argument unpersuasive.

The court found that the taxpayer used the exchanges to cash out of an investment in low-basis real property, noting that the taxpayer decreased its investment in real property by approximately $13 million , and increased its cash position by that same amount. The court surmised "these transactions were undoubtedly structured in contravention of Congress's desire that nonrecognition treatment only apply to transactions 'where a taxpayer can be viewed as merely continuing his investment.' "

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