INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: District Counsel,

Attn:

FROM: Heather C. Maloy
Associate Chief Counsel (Income Tax & Accounting)

SUBJECT: and v. Commissioner

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LEGEND

= Year 1

	=	A
	=	W
	=	B
	=	B1
	=	B2
	=	D
	=	E
	=	F
	=	G
	=	H
	=	the law firm
	=	Y
	=	Z
	=	Company I
	=	Property X
	=	Property Y
$	=	Amount L
$	=	Amount M
$	=	Amount N
$	=	Amount O
$	=	Amount P
$	=	Amount Q
$	=	Amount R

= Date i

= Date ii

= Date iii

= Date iv

= Date v

= Date vi

= Date vii

= Date viii

= Date ix

= Date x

= Date xi

= Date xii

= Date xiii

= Date xiv

= Date xv

= Month A

= Month B

ISSUES

1. Whether Petitioners are entitled to nonrecognition of gain under I.R.C. § 1031(a) in Year 1 on the exchange of A’s interest in property X for property Y.

2. Whether A's transfer of property to his children satisfies the requirements for related person transfers under I.R.C. § 1031(f).

CONCLUSIONS:

1. Petitioners are not entitled to nonrecognition of gain on the exchange of A's interest in Property X for an interest in Property Y in Year 1 under section 1031(a).

2. The transaction between A and his children is not a related person exchange within I.R.C. § 1031(f).

FACTS

The following facts are based on your memorandum, and the documentation you provided. A and W [referred to collectively as "petitioners"] filed joint tax returns for Year 1, the tax year at issue. Although petitioners filed joint returns for Year 1, only A engaged in the exchange transaction. A owned Property X. A wished to sell Property X to his children, D, E, F, and G [referred to collectively as "children"]. An exchange agreement was drawn up among A, the children, and B, which was referred to as an escrow agent. The agreement was unsigned and undated. The exchange agreement indicated that A and the children entered into a Purchase Agreement relating to the purchase of Property X. This property was not identified in the exchange agreement. Rather, the exchange agreement referenced an "Exhibit A" for a description of Property X. Neither the Purchase Agreement nor the Exhibit A were provided by petitioners.

The exchange agreement provided that the parties intended a like-kind exchange between A's relinquished property and real property to be identified by him as replacement property. The parties agreed that the replacement property must be acquired no later than 180 days after the transfer of the relinquished property. The replacement property could be acquired by the children at A's request. On the Transfer Date (which was specified in the Purchase Agreement), A would deliver the children a deed to the relinquished property, and the children would pay the sales proceeds to B, which would hold the monies in an interest-bearing escrow account. The agreement prohibited A from receiving any part of the sale proceeds either 45 days after the transfer of the relinquished property or before the closing date of the replacement property provided that the children present an executed sales contract in a form satisfactory to A setting forth the terms for acquiring the replacement property.

On Date ii, A sold four tracts of Property X to his children for Amount M. A deeded the property directly to his children. On the same day, the children executed a promissory note of Amount M which designated A as the lender and B as the escrow agent. The note provided that interest would be charged at the applicable federal rate commencing on Date xii, and that the principal balance would be due on demand. It is not clear what person or entity held the promissory note. On Date xv, Revenue Agent B2 interviewed

B1, formerly a senior commercial lender for B, with whom A dealt regarding this transaction. B1 did not recall ever having received a promissory note.

The children did not own property with which to complete the exchange. Accordingly, A sought replacement property. A wrote a letter to B1 on Date v informing him that he had located replacement property owned by H. The letter stated as follows: "As escrow agent I would like to identify property for the 1031 exchange. I am exchanging [Property X] at a cost of [Amount M] on [Date ii], for [Property Y] which costs [Amount N]." The letter contained A's name in typeface, and was signed Z. On or about Date vii, A and H entered into a contract of sale.

On Date viii, the children wrote checks for their portions of the Amount M purchase price. The checks were made payable to the law firm, and the memo portion of three of the childrens' checks indicated "A escrow." It is not clear who retained the law firm. You believe that from the evidence you have obtained thus far, A retained the law firm and paid all legal fees.

On Date ix H directly deeded the replacement property to A. The closing statement lists the total amount due from A as Amount O, which included a reduction in the Amount N purchase price by the "credit from 1031 transfer" of Amount M. A's check in Amount O was made payable to the law firm.

The children sold small portions of Property X to unrelated third parties in six separate sales between Date iv and Date xiii. The first sale occurred on Date iv, and consisted of approximately six acres. A (through his Company I) entered into a sales contract on Date i with an unrelated third party for a portion of Property X. On Date ii, A transferred the entire Property X to his children pursuant to the exchange agreement. The children subsequently sold a portion of Property X to the same third party on Date iv for Amount L. In addition to this sale, the children sold five other portions of the property to this and other unrelated third parties from Date x through Date xiii. The total sales proceeds over the two year period were Amount P.

Petitioners filed a Form 8824 with their Year 1 return which asserted that the Amount Q of gain they received from the exchange was deferred by virtue of section 1031. The Service issued a notice of deficiency for tax Year 1 on Date xi which asserted that the gain from the sale of taxpayers' real property did not qualify for nonrecognition, and increased taxpayers' taxable income by Amount Q. A and his spouse filed a petition with the Tax Court on Date xiv in which they asserted that A entered into an exchange agreement with B, (which petitioners identified as a qualified intermediary), and the children to effect a section 1031 exchange. Petitioners asserted that the Commissioner erred in increasing their taxable income since the exchange satisfied the requirements of section 1031.

LAW AND ANALYSIS

ISSUE 1

Whether Petitioners are entitled to nonrecognition of gain under I.R.C. § 1031(a) in Year 1 on the exchange of A's interest in property X for property Y.

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

Section 1031(a)(3) allows taxpayers to engage in a deferred, rather than a simultaneous, exchange. Section 1.1031(k)-1(a) provides that a deferred exchange is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the "replacement property").

Petitioners are not entitled to nonrecognition of gain under section 1031(a). The transaction does not comply with several requirements of section 1031 and the regulations thereunder for the following reasons: first, B does not satisfy the regulations' definition of a qualified intermediary; second, A failed to unambiguously identify replacement property; third, A was in constructive receipt of the proceeds from the transfer of Property X prior to his receipt of Property Y; and fourth, the terms of the exchange agreement violate the anti-constructive receipt rules. Each ground of noncompliance with the Code and Regulations is explained below.

Constructive Receipt of Proceeds of Relinquished Property

Section 1.1031(k)-1(a) provides in part that in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) sets forth standards defining actual and constructive receipt. A taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. A taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer’s account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Actual or constructive receipt of money or property by an agent of the taxpayer is actual or constructive receipt by the taxpayer.

A sold the relinquished property to his children for Amount M on Date ii. On Date viii, each of the children wrote a check for his or her one quarter portion of the Amount M purchase price. The checks were made payable to the law firm, and the memo portion of the checks written by the children indicated “A escrow.” B1 stated in his interview that he did not recall ever receiving any funds or note from the sale of Property X. If the law firm was retained by A, as you believe, and the law firm, rather than B, held the proceeds from Date viii, then A was in constructive receipt of the sale proceeds since the law firm, as A’s agent, held the proceeds prior to A's receipt of Property Y. The only evidence in the documentation provided that B held the sales proceeds from Property X is A’s representation to his son, and a representation in petitioners’ complaint. The letter, apparently addressed to A’s son, E, and signed by Y, (whom you indicated was probably A) stated that A’s escrow agent is holding the Amount M from the Date ii closing of Property X. A did not identify the escrow agent in the letter.

<u>Exchange Agreement Violates the Anti-Constructive Receipt Rules</u>

The terms of the exchange agreement violate the anti-constructive receipt rules of Treas. Reg. 1.1031(k)-1(g)(6). This section provides that to avoid a determination that the taxpayer is in actual or constructive receipt of money or other property, an agreement must limit a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period, except as provided in (g)(6)(ii) or (iii). Under the exception provided in section (g)(6)(ii), the agreement may state that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period. Under the (g)(6)(iii) exception, the agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after either the receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or the occurrence after the end of the identification period of a material and substantial contingency that relates to the deferred exchange, is provided for in writing, and is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer.

As stated above, the agreement prohibited taxpayer from receiving any part of the sale proceeds either before the sale of the replacement property or 45 days after the transfer of the relinquished property. Clause 3 of the agreement specifically provides:

> Escrow Agent shall hold said net proceeds of sale [of the relinquished property] in an interest bearing account or in such other form of investment as it may deem reasonable until (a) 45 days after the Transfer Date, [of the relinquished property] or (b) the date or dates of closing of the acquisition of Exchange Property [replacement property] provided that Buyers [the children] present to Seller [A] prior to 45 days after the Transfer Date properly executed Sales Contract(s) in a form satisfactory to Seller setting forth the terms for the acquisition of Exchange Property. If one or more Sales Contracts are not presented and accepted by Seller in writing (such acceptance to be in Seller's absolute discretion) by 45 days after the Transfer Date with notice to Escrow Agent, the Escrow Agent shall at the close of business on the 45th day after the Transfer Date distribute all funds, proceeds of the closing and interest on income thereon, in the escrow to the Seller. If one or more Sales Contracts acceptable to seller are presented on or prior to 45 days after the Transfer Date, Escrow Agent shall continue to hold funds until the closing of the acquisition of Exchange Property and thereupon to distribute such funds as directed by Seller or, in the event such acquisition does not close as contemplated in such Sales Contract, to distribute such funds to Seller.

Treas. Reg. § 1.1031(k)-1(g)(6) extends the anti-constructive receipt rules throughout the 180-day exchange period. Under section 1.1031(k)-1(g)(6)(ii), the agreement may state that if the taxpayer has not identified replacement property by the end of the 45 day identification period, the taxpayer may have the right to receive the proceeds in escrow. The present agreement, on the other hand, permits a distribution of the proceeds if the Seller has not accepted the sales contract(s) presented to him by 45 days after the transfer date. The terms of this provision do not limit A's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. If a sales contract is presented to the Seller, but the Seller rejects it after the 45-day period, then the agreement may be interpreted to allow the Seller to obtain the escrow funds prior to his receipt the replacement property. This provision violates the identification provisions of section 1031(a)(3)(A), which require that replacement property must be identified within 45 days of the transfer date of the relinquished property. There is no requirement in section 1031(a)(3)(A) that a contract must be accepted by a taxpayer in order for a valid identification to occur. Since the agreement can be interpreted to mean that no valid identification occurs if the sales contract is presented to the Seller within the 45-day period, but rejected after the 45 day period, it violates both section 1031(a)(3)(A) and the anti-constructive receipt rules of Treas. Reg. § 1031(k)-1(g)(6).

B is Not a Qualified Intermediary

Treas. Reg. § 1.1031(k)-1(g)(4)(iii) provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person and who enters into a written agreement with the taxpayer and as required by the agreement acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. Treas. Reg. § 1.1031(k)-1(g)(4)(iv) provides: (A) an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property, (B) an intermediary is treated as acquiring and transferring the relinquished property if the intermediary enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person, and (C) an intermediary is treated as acquiring and transferring replacement property if the intermediary enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer. 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. Treas. Reg. § 1.1031(k)-1(g)(4)(v).

B does not satisfy the requirements for a qualified intermediary since it failed to participate in any way in the transfer of Property Y, the replacement property. H directly deeded Property Y to A. B did not acquire legal title to Property Y and transfer it to A pursuant to Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(A). B did not enter into an agreement with H for the sale of Property Y, and thus did not fulfill Treas. Reg. § 1.1031(k)-1(g)(4)(iv)(C). Neither A nor H assigned their rights in the purchase agreement for Property Y to B pursuant to Treas. Reg. § 1.1031k-1(g)(4)(v). B is not treated as acquiring or transferring Property Y to A, and is therefore not a qualified intermediary. Consequently, A did not exchange Property X for Property Y. The transaction instead constituted a sale and purchase. A sold Property X to his children and purchased

Property Y from H.

Invalid Identification of Replacement Property

Section 1031(a)(3) provides that for purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if such property is not identified as property to be received in the exchange on or before 45 days after the transfer date for the relinquished property (the "identification period"), or such property is received after the earlier of either (i) 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (determined with regard to extension) for the transferor's tax return for the taxable year in which the transfer of the relinquished property occurs (the "exchange period"). When an exchange transaction is deferred, even if the taxpayer trades property for other property of the same asset or product class, the exchanged properties will not be of like-kind if the replacement property is not timely identified or received. Treas. Reg. § 1.1031(k)-1(a).

Treas. Reg. § 1.1031(k)-1(c)(3) provides that replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name.

A wrote a letter to B1 on Date v which identified the replacement property as follows: "As escrow agent I would like to identify property for the 1031 exchange. I am exchanging [Property X] at a cost of [Amount M] on [Date ii], for [Property Y] which costs [Amount N]." This identification does not satisfy the requirements for a valid identification, as it is too ambiguous, and leaves A with too many potential choices of replacement property. The identification in Example 3 of Treas. Reg. § 1.1031(k)-1(c)(7) is similar to the present identification. The example provides that B identifies the replacement property as "unimproved land located in Hood County with a fair market value not to exceed $100,000." The example concludes that the replacement property was not unambiguously identified.

Even if a taxpayer does not unambiguously describe the replacement property, a taxpayer's identification may still be valid if replacement property is received by the taxpayer before the end of the 45 day identification period set forth in I.R.C. § 1031(a)(3)(A). See Treas. Reg. § 1.1031(k)-1(c)(1). Section 1031(a)(3)(A) provides that the identification period runs for 45 days after the date on which taxpayer transfers the property relinquished in the exchange. In the present case, A did not actually receive the replacement property within the 45 day identification period. The identification period ran from Date iii through Date vi. A received the replacement property on Date ix.

Because the identification was invalid, the replacement property fails to qualify as like-kind property. The exchange fails to qualify for section 1031 treatment since no replacement property was identified before the end of the identification period.

ISSUE 2

Whether A's transfer of property to his children satisfies the related person requirements under I.R.C. § 1031(f).

Section 1031(f) contains special rules for exchanges between related persons. A related person is defined under section 1031(f)(3) as any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1). Sections 267(b) and (c)(4) include as related taxpayers family members, including lineal descendants.

Section 1031(f)(1) provides that 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) within 2 years of the date of the last transfer which was part of such exchange either the taxpayer or the related person disposes of property received in the exchange, then there shall be no nonrecognition of gain or loss to the taxpayer with respect to such exchange unless one of the exceptions stated in section 1031(f)(2) applies.

A and his children clearly fall within the definition of related person for purposes of section 1031(f)(1). Nevertheless, section 1031(f) is not applicable to the facts here. The transaction does not qualify as an exchange between related persons because it fails to satisfy sections 1031(f)(1)(A) and (B). A did not exchange property with his children, but rather sold Property X to them. For the reasons stated in issue 1, the transaction does not qualify for nonrecognition of gain under section 1031. Regarding section 1031(f)(1)(C), the childrens' sale of six parcels of Property X from Date iv through Date xiii violates the 2 year prohibition on the transfer of property received in the exchange, even though only a small portion of the property was sold within this period. The childrens' sales occurred prior to and within 2 years of Date ix, the date of the last transfer in the exchange.

Section 1031(f)(2) provides three exceptions to the prohibition on nonrecognition of gain for transfers occurring within the 2 year period, as provided in section 1031(f)(1)(C). The only exception relating to the facts of this case is provided in section 1031(f)(2)(C). This section provides that section 1031(f)(1)(C) does not apply to any disposition with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. The non-tax avoidance exception applies to transactions that do not involve the shifting of basis between properties. H.R. CONF. REP. NO. 101-386, at 614 (1989). The purpose of the exception is to prevent related parties from shifting basis from a low basis asset to a high basis asset in anticipation of the sale of the low basis asset to reduce gain recognition on the disposition of the low basis asset. STAFF OF HOUSE BUDGET COMM., H.R. Rep. No. 101-247, 101st CONG., 1st Sess., at 1340 (1989); SENATE FINANCE COMM. EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON OCTOBER 3, 1989, S. REP. 101-56, at 151, 152 (1989). As further stated in the House and Senate Committee Reports, if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have "cashed out" of the investment, and the original exchange should not be accorded nonrecognition treatment. Id. The Report concluded that taxpayers must hold the property exchanged and property received for a significant period of time to evidence a continuity of investment. Id.

Petitioners have argued that their transaction falls within the anti-tax avoidance exception of section 1031(f)(2)(C). Petitioners, however, cannot avail themselves of this argument since this exception only applies to related person exchanges for which there is nonrecognition of gain or loss to the taxpayer. Even if we assume that A exchanged property with his children and that the present transaction qualifies for nonrecognition of gain, the transaction does not qualify for the anti-tax avoidance exception. The following facts demonstrate that basis shifting occurred. A transferred his low basis Property X, in which he had a basis of Amount R at the time of the transfer, to his children. He then acquired high basis property from H and paid the proceeds from the sale of Property X (plus an additional amount) to H. The children subsequently sold portions of Property X between Date iv and Date xiii, with sales proceeds totaling Amount P. A wished to avoid recognizing a considerable amount of gain on the sale of Property X, and to accomplish this, he transferred Property X to his children. As noted above, A entered into a contract of sale for a portion of his interest in Property X to a third party in Month A of Year 1, but then decided to transfer his entire interest to his children in Month B of Year 1 to avoid recognizing the gain. In Month B of Year 1, the children sold the interest to the same third party.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

For the foregoing reasons, the Commissioner's finding that the transaction does not qualify for nonrecognition of gain should be sustained. [redacted]

Please call (202) 622-7900 if you have any further questions.

Sincerely,
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