CLIENT REPORT

The Pitfalls and Opportunities in Like-Kind Exchanges

Dear Client:

This letter is in reply to your questions regarding the federal income tax consequences of a "like-kind" exchange. The principal advantage of a like-kind exchange is that taxable gain is not triggered at the time of an exchange but, instead, that gain is deferred and added to the gain that will eventually be taxed upon the sale or other disposition of the exchanged property. Alas, from such a simple principal, however, comes a set of federal income tax rules that will make your head spin.

Deferred exchange. If the exchange of properties is not simultaneous, the property to be received must be identified within 45 days after the date the relinquished property is transferred. In addition, the identified property must be received within 180 days after the date of transfer or the extended due date for the return for the tax year in which the transfer occurred, whichever date is earlier.

Several other potential pitfalls may threaten to derail deferred exchanges (e.g., failure to adhere to certain time limits and/or meet qualified intermediary requirements). To recognize a loss, however, the transaction must be arranged so that Internal Revenue Code Section 1031 does not apply, e.g., purposefully arranging the transaction as a sale. Even if this is done, the IRS may still argue substance over form to deny the loss.

Safe harbors in deferred exchange. In a deferred exchange, the "seller" cannot actually or constructively receive money or other property for the relinquished property before the replacement property is received. To protect a seller who has given up his property but has received nothing in return except a promise to acquire replacement property in the future, several safe harbors in particular have been utilized by practitioners to prevent the transaction from being treated as a sale. The "buyer" can deposit cash into an escrow account or provide a letter of credit or third-party guarantee. Alternatively, the seller can transfer his property to a qualified intermediary (defined in Treasury regulations). A qualified intermediary will acquire the replacement property with funds furnished by the buyer and then transfer the relinquished property to the buyer and the replacement property to the seller.

Contribution to another entity. The transfer of replacement property to an entity may be desired for nontax purposes but could be viewed as violating the investment or trade or business use requirement, thereby jeopardizing Code Sec. 1031 treatment. For example, the IRS held in Rev. Rul. 75-292, that replacement property contributed to a corporation for stock shortly after an exchange was not a continuation of the real property investment. However, the Tax Court distinguished Rev. Rul. 75-292 in *Magneson v Commr* , when it allowed an immediate contribution of replacement property to a partnership.

The Tax Court in *Mason v Commr* (1988) also recognized a nontaxable exchange when a partnership first distributed property to its partners before the exchange. Since not all of the partners desired like-kind treatment, they were free to make their own arrangement to recognize or not to recognize gain. Limited liability companies (LLCs) with at least two members are similarly treated.

Recent ruling. The IRS in a recent Letter Ruling held that the conversion of two LLCs treated as partnerships into limited partnerships did not result in termination of either LLC under Internal Revenue Code Section 708 and the respective limited partnerships were considered a continuation of the respective LLCs. Furthermore, the partnerships were treated as both the transferors of the relinquished properties and the transferees of the replacement properties.

In this latest ruling, the taxpayers intended to exchange hotels in one state for resort hotels in another state through a qualified intermediary. Each LLC was to be liquidated, with the assets transferred to the new limited partnership. Following the formation of partnerships and on or before 180 days following the transfer of the relinquished property to the qualified intermediary, the qualified intermediary would transfer the replacement property to the partnerships. The stated business purpose for the formation of the partnerships was to satisfy the requirements of potential lenders that the acquiring entities of the replacement properties be separate and apart from the owners of the relinquished properties as a safeguard against any liabilities carrying over to the replacement properties.

We hope that this letter gives you an understanding of the many variables that should be considered before a "like-kind" exchange is undertaken in place of a contemplated ordinary sale. Please call to discuss how these rules may interrelate with your specific circumstances and how we can achieve the most advantageous results for you.

Sincerely yours,

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