BRADFORD TAX INSTITUTE

Tax Reduction Letter

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Technical Advice Memorandum 201437012

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 18, 2014

LEGEND:

Taxpayer	=
Year 1	=
Equipment	=
Area X	=
Y	=
$a	=
Z	=
$b	=
$c	=

ISSUE:

In like-kind exchange program (hereafter "LKE Program") transactions, if certain properties previously matched as replacement properties are later determined to be ineligible as replacement properties under § 1031 of the Internal Revenue Code, but Taxpayer timely identified and acquired other eligible properties that were not previously reported as matched, may these other eligible properties qualify as replacement properties?

CONCLUSION:

In LKE Program transactions, if certain properties previously matched as replacement properties are later determined to be ineligible as replacement properties under § 1031, other eligible replacement properties that were timely identified and acquired, but not reported as matched, qualify as replacement properties.

FACTS:

Taxpayer distributes, sells, services, rents, and finances Equipment to private, public and government entities in Area X through stores operated by wholly-owned subsidiaries. Its equipment rental business is operated as a separate division from its equipment sales, services and financing businesses. Within its rental division, Taxpayer established a § 1031 LKE Program, as permitted under Rev. Proc. 2003-39, 2003-1 C.B. 971.

In Year 1, Taxpayer acquired Y individual pieces of equipment that it designated as replacement properties at a total cost of $a. During the same year, Taxpayer disposed of and exchanged through its LKE Program Z pieces of equipment designated as relinquished properties, which yielded proceeds of $b. Thus, the total cost of the replacement properties exceeded the proceeds from the relinquished properties by $c. These transactions were not exchanges of multiple properties as defined in §1.1031(j)-1(a) of the Income Tax Regulations. Rather, for each transaction under consideration, only one exchange group was created and Taxpayer received one replacement property for each property relinquished. These transactions were structured as like-kind exchanges through a qualified intermediary under a master exchange agreement pursuant to Rev. Proc. 2003-39. Taxpayer used an automated algorithm to match replacement properties to relinquished properties. This automated algorithm applied a “first-in-first-out” (FIFO) methodology under which the first replacement property identified and received within the prescribed statutory and regulatory timeframes was matched against the relinquished property. The excess replacement properties that were not needed as replacement properties in the LKE Program were capitalized at full cost and amortized as rental equipment, as provided under section 3.02(10) of Rev. Proc. 2003-39.

The Examination Team determined that some of the replacement properties were not eligible for exchange under § 1031 because they were held primarily for sale rather than for productive use in a trade or business or for investment.

In response, Taxpayer asserts that it has other previously unmatched replacement properties which it should match with the eligible relinquished properties. For these other assets, which were also acquired within the relevant 45-day identification period, there is no eligibility issue. Taxpayer argues that § 1031 and the authorities thereunder require it to re-match the eligible relinquished properties to the other previously unmatched eligible replacement properties.

The Examination Team disputes this position, arguing that Taxpayer's matching of ineligible replacement properties with the relinquished properties is binding on Taxpayer upon filing of its return. The Examination Team urges that a later rematch is not permitted.

APPLICABLE LAW:

Section 1031(a)(1) generally 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) provides that for purposes of § 1031(a), any property received by the taxpayer shall be treated as property which is not like-kind property if: (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange; or (B) such property is received after the earlier of—(i) the day which is 180 days after the date on which the taxpayer transfers property relinquished in the exchange, or (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed for the taxable year in which the transfer of the relinquished property occurs.

Section 1031(b) provides, in part, that if an exchange would be within the provisions of subsection (a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1.1031(k)-1(a) of the regulations provides rules for the application of § 1031 in the case of a "deferred exchange." A deferred exchange is defined as an exchange in which, pursuant to an agreement the taxpayer transfers property (the "relinquished" property) and subsequently receives property (the "replacement" property). It further provides, *inter alia*, that in order to qualify as replacement property the property must be identified and received in accordance with § 1.1031(k)-1(b), (c) and (d).

Section 1.1031(k)-1(b)(1)(i) provides, in part, that in the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like-kind to the relinquished property if the replacement property is not "identified" before the end of the "identification period."

Section 1.1031(k)-1(b)(2)(i) provides that the identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

Section 1.1031(k)-1(c)(1) provides that any replacement property that is received by the taxpayer before the end of the identification period will "in all events be treated as identified before the end of the identification period." *See also* § 1.1031(k)-1(c)(4)(ii)(A). Thus, where multiple replacement properties are received within the 45- day identification period following a transfer of a relinquished property then all the replacement property received during that period will "in all events" be treated as identified as replacement property for the subject relinquished property.

Section 1.1031(k)-1(f)(1) provides, in part, that if a taxpayer 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 property.

Rev. Proc. 2003-39 provides safe harbors that clarify the application of § 1031 and the regulations thereunder with respect to LKE Program exchanges of tangible personal property using a single intermediary.

Section 3.01 of the revenue procedure limits its application to providing safe harbors for only certain aspects of LKE Program exchanges under § 1031. For a transaction to qualify under § 1031 it must also satisfy the requirements of § 1031 for which safe harbors are not provided. For example, for a transaction to qualify for deferral of gain or loss under § 1031, the properties exchanged must still be of like kind.

Section 3.02 defines an "LKE Program" as an ongoing program involving multiple exchanges of 100 or more properties and having all other characteristics of an LKE Program, as listed in that subsection.

Section 3.02(10) provides that the taxpayer recognizes gain or loss on the disposition of relinquished properties that are not matched with replacement properties, and the taxpayer takes a cost basis in replacement properties that are received but not matched with relinquished properties.

Section 3.03 provides that exchanges of property pursuant to an LKE Program may qualify for nonrecognition treatment even though they fall outside the safe harbors and that no inference is intended with respect to the federal income tax treatment of exchanges that do not satisfy the terms of the safe harbors of the revenue procedure.

Section 3.04 provides that each of the safe harbors is separate and distinct and that a taxpayer who fails to qualify for one safe harbor may nevertheless qualify for another.

Section 4 of Rev. Proc. 2003-39 sets forth safe harbors with respect to relinquished property and replacement property.

Section 4.01 provides generally that each exchange within an LKE Program is treated as a separate and distinct exchange and that the determination of whether a particular exchange qualifies under § 1031 is made without regard to any other exchange. Thus, if a particular exchange fails to qualify under § 1031, such failure will not affect the application of § 1031 to any other exchange.

Section 4.02 provides, in part, that the replacement property must be matched no later than the due date (determined with regard to extensions) of the taxpayer's return.

ANALYSIS:

Section 1031 is not an elective provision. It applies to defer gains and losses whenever property held for productive use in a trade or business or for investment is exchanged for like-kind property that is also held for productive use in a trade or business or for investment. As a mandatory, non-elective provision, § 1031 applies even if the taxpayer is unaware that a like-kind exchange has occurred or tries to avoid § 1031 treatment by papering its exchanges as sale and purchase transactions. *See Redwing Carriers, Inc. v. Tomlinson,* 399 F.2d 652 (5th Cir. 1968) (reciprocal trade-in of old equipment and purchase of new equipment by a related entity qualified as like-kind exchange even if treated as unrelated purchase and sale by taxpayer). *See also* Rev. Rul. 61-119, 1961 C.B. 395. In other words, how a taxpayer reports a transaction on its income tax return does not determine whether § 1031 applies to the transaction. Taxpayer's characterization of the transaction on Form 8824 ("Like-Kind Exchanges") or elsewhere on the income tax return cannot override the application of either § 1031 or the treasury regulations to transactions qualifying as like-kind exchanges.

The deferred exchanges at issue in this case are governed by § 1031(a)(3) of the Code and § 1.1031(k)-1 of the regulations. Under the given facts, the unmatched replacement properties were properly identified because they were received by Taxpayer under the LKE Program before the end of the identification period, consistent with § 1.1031(k)-1(c)(1) and (4)(B)(ii)(A). Section 1.1031(k)-1(c)(4) of the regulations expressly allows a taxpayer to identify multiple and alternative replacement properties in a deferred exchange. Thus, the time requirements for identification and receipt of previously unmatched replacement properties were satisfied. Since the previously unmatched replacement properties meet the requirements of exchange, identification and receipt, § 1031 requires nonrecognition and rematching is appropriate.[1]

Nothing in Rev. Proc. 2003-39 contradicts this conclusion. Rev. Proc. 2003-39 sets forth safe harbors to assist taxpayers in administering high volume LKE Programs such as the program at issue here. These programs are characterized by a continuous outflow and inflow of large numbers of both relinquished and replacement properties, without any direct connection between ongoing dispositions of relinquished property and ongoing acquisitions of replacement property. Unlike a traditional reciprocal one-for-one property exchange, where specific properties are exchanged for specific properties, in an LKE Program under a master exchange agreement, with blanket assignments to the intermediary and blanket notices of assignments, the intermediary disposes of property and acquires replacement property, most likely before any matching occurs.[2] So long as eligible like-kind replacement property is identified and received in an exchange within legally prescribed timeframes, § 1031 applies.

Rev. Proc. 2003-39 introduces the concept of "matching" of relinquished properties with replacement properties primarily to facilitate computation and administration in these large scale LKE Programs. The revenue procedure does not mandate any particular procedure for matching replacement properties with relinquished properties. Further, the revenue procedure does not mandate that the taxpayer match replacement properties with relinquished properties at the time of the exchange. It only requires that the match be made by the extended due date of the taxpayer's return for the year of the exchange.

Taxpayer used an automated "FIFO" methodology under which the first replacement property identified and received within the statutory and regulatory timeframes was matched against the relinquished property. As a safe harbor revenue procedure, Rev. Proc. 2003-39 does not support the conclusion that a taxpayer is bound by its selection of replacement property if that property is later found ineligible and Taxpayer has other eligible replacement property that was not already treated as replacement property in an exchange.

The Examination Team points to § 1.1031(k)-1(f)(1) of the regulations as disallowing the taxpayer from rematching property. That subsection, however, deals with the situation in which a taxpayer actually sells the relinquished property and receives money or other property "in the full amount of consideration for the relinquished property" before receiving like-kind replacement property. It provides that a sale is not converted into an exchange by the happenstance of a later receipt of like-kind property. Under the facts

[1] If Taxpayer receives cash or unqualified property through the qualified intermediary (which is not a separate purchase under section 3.02(10) of Rev. Proc. 2003-39) along with qualified replacement property, the cash or unqualified property it taxable as boot, pursuant to § 1031(b).
[2] See Rev. Proc. 2003-39, section 3.02 (3), (5) and (6) regarding the master exchange agreement, blanket assignments and blanket notices of assignments, respectively.

of the present case, Taxpayer exchanged the relinquished property for replacement property. Through the qualified intermediary, Taxpayer also received ineligible property and paid boot into the exchanges to acquire some of the replacement property. During the exchange period, however, Taxpayer did not receive money or other property without also receiving qualifying replacement property for the relinquished property. Therefore, Taxpayer did not sell the relinquished property.

The Examination Team also urges that to allow rematching of replacement properties after the due date of the taxpayer's return is contrary to the intent of Congress when it added § 1031(a)(3) to the Code, limiting the period for identifying and acquiring replacement properties in deferred exchanges. The Examination Team cites to the House Ways and Means Committee report of this provision which states that "[t]o the extent that the taxpayer is able to defer completion of the transaction . . . the transaction begins to resemble less a like-kind exchange and more a sale of one property, followed, at some future point, by a purchase of a second property or properties." H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1232 (1984). In other words, the greater the taxpayer's discretion to vary the particular property to be received in exchange for the relinquished property and to vary the date on which such replacement property (or money) is to be received, the more the transaction is appropriately treated as a sale and not as a like-kind exchange.

We agree that long delays in identification and receipt of replacement properties would raise doubts as to whether properties are of like kind or whether they are truly exchanged. However, the facts presented in this case assume the relevant properties are of like kind and the potential replacement properties are received within the 45-day identification period, which is well-within the statutory exchange period. Thus, there is no issue of sale presented here.

Next, the Examination Team cites *Bavlev v. Commissioner*, 35 T.C. 288, 298 (1960) for the proposition that, for Federal tax purposes, binding elections exist whenever a taxpayer has a free choice between two or more alternatives and communicates that choice to the Commissioner. The Bavlev case discussed installment sale treatment under § 453 of the 1954 Code. At that time, a taxpayer could report certain transactions on the installment method if the taxpayer made a timely election to do so. However, as discussed, § 1031 is not elective. Further, the reporting of a match has no bearing on whether a § 1031 exchange took place. Adopting the Examination Team's position would make § 1031 elective by the taxpayer's choice of match. This is inconsistent with § 1031(a) and *Redwing Carriers*.

Finally, the Examination Team raises the concern that to allow rematching after the due date of the return for the year of the exchange in question would place an unworkable administrative burden on the Service in examining exchanges in an LKE Program. The Examination Team states that if the taxpayer may rematch each time there is a proposed adjustment, the taxpayer's purported exchanges would remain a moving target up until the expiration of the statute of limitations. In addition, aggressive taxpayer behavior would raise concerns about whether the taxpayer was conducting a bona fide mass LKE Program or was actually selling property.

The facts of this request do not show that Taxpayer is conducting a mass LKE Program in bad faith or attempting to outlast the statute of limitations. Unquestionably, there is additional burden on Exam resulting from Taxpayer's ability to rematch property upon determination by Exam that the originally matched replacement property is ineligible. Exam must verify that the newly matched replacement property qualifies for § 1031 treatment and must make any necessary adjustments resulting from the substitution. Unfortunately, this is an unavoidable burden inherent in a provision of the Code that does not irrevocably bind the taxpayer and the IRS to the position originally reported by the taxpayer on its return.

CAVEAT(S):

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