

2015

# No “basis shifting” in related party like-kind exchange

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## Recommended Citation

Harl, Neil E. (2015) "No “basis shifting” in related party like-kind exchange," *Ag Decision Maker Newsletter*: Vol. 11 : Iss. 6 , Article 2.  
Available at: <http://lib.dr.iastate.edu/agdm/vol11/iss6/2>

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No "basis shifting" in related party like-kind exchange

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In a late 2006 private letter ruling, the Internal Revenue Service took the position that, in a like-kind exchange of real property among related parties, there was no "basis shifting" because of the effect of a recent death on the income tax basis of the properties.

Thus, the avoidance of federal income tax was not a principal purpose of the exchange or the subsequent disposition of one of the tracts of real property and the disposition of that tract within the two year period after the exchange did not result in recognition of gain. To the extent the ruling represents solid authority, it provides a modicum of comfort for those planning a like-kind exchange involving related parties where cashing out is anticipated by one or more of the parties.

The facts of the ruling

In the ruling the father, now deceased, had acquired several tracts of timberland which were held for the production of income and for investment purposes.

At the father's death, Parcel #1 was transferred to his wife. Parcels #2 and #3 were transferred to a trust. The mother then proceeded to transfer Parcel #1 as a gift to her children in equal undivided interests as tenants in common. The trust held Parcels #2 and #3 for the benefit of the mother during her life with the children as remainder beneficiaries of the trust's assets.

The trustee and the children decided to sell all of the real estate holdings including Parcels #1, #2 and #3. Because one of the children, the taxpayer, did not want to divest herself of her ownership in the real estate, she agreed to exchange her 25 percent interest in Parcel #1 for a 100 percent interest in Parcel #3. The interests transferred were of equal value and, because of the effect of the father's death, the basis figures bore the same relationship to fair market value. After the exchange, the trust and the children sold Parcels #1 and #2 to an unrelated third party.

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The holding in Ltr. Rul. 200706001

The Internal Revenue Service concluded that the exchange of the taxpayer's 25 percent interest in Parcel #1 for a 100 percent interest in Parcel #3 was a like-kind exchange. In addition, the subsequent sale by the trust of its interest in Parcel #1 was not a disposition that caused recognition of gain to the taxpayers under I.R.C. § 1031(f) "... because the avoidance of Federal income tax was not one of the principal purposes of the exchange or subsequent disposition of Parcel #1."

The ruling cites legislative history for the proposition that "... dispositions that do not involve the shifting of basis between properties are not taken into account under § 1031(f)(1)©." The taxpayers represented that the respective per-acre bases for the two tracts (#1 and #3) were equivalent as a result of the step-up in basis which occurred when the father had died.

Therefore, because IRS was convinced that one of the principal purposes of the exchange was not the avoidance of federal income tax, the two-year rule did not apply, and no gain was triggered on sale of Parcel #1.

No "cashing out"

In recent months, concerns have been raised in rulings and in a Tax Court case which denied non-recognition treatment for transactions in which related parties made like-kind exchanges of high basis property for low basis property in anticipation of sale of what had originally been low basis property. Such a transaction is viewed as an exchange which is part of a transaction--or series of transactions--to avoid the related party rule and the non-recognition provisions of I.R.C. Sec. 1031 do not apply.

However, in the latest ruling, the exchange did not involve tracts with significantly different basis figures which satisfied IRS that the transaction did not have "... as one of its principal purposes the avoidance of Federal income tax."

No mention of "partnership"

Despite the fact that Parcel #1 was owned in co-ownership (tenancy in common) by the siblings, no mention was made of that in the ruling. In recent years, much has been made of the fact that co-ownership in some instances may be deemed to be a partnership. In 2002, IRS issued Rev. Proc. 2002-22 which specified 15 conditions that had to be met for a favorable advance ruling on the proposed exchange where a like-kind exchange involving co-owned property was involved. IRS also removed the provision signaling that rulings would not be issued in that area.

Apparently, IRS was not concerned about that aspect in the latest ruling (which apparently did not involve a request for an advance ruling on that issue) although the ruling was in response to a request for a private letter ruling from the taxpayer. This is consistent with rulings in recent years agreeing that co-ownership situations were not considered to be partnerships.

In conclusion

Although the use of Section 1031 exchanges involving farmland apparently has declined in recent months, the concept continues to be widely used. The latest ruling provides useful guidance in related party exchanges.

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"Adjustable cash rent leases" and division of farm program payments

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In recent months, farm tenants have expressed interest in adjusting existing cash rent leases in an attempt to broker some of the risk associated with rising commodity prices and the stave off the possibility that the landlord will raise the cash rental rate. But, there's a potential problem with fiddling with cash rent leases - how might any adjustment impact the way farm program payments are split between the tenant and the landlord?

Under Farm Service Agency (FSA) rules, if a lease is a cash lease, then the tenant is entitled to the government payments. For share leases, the payments must be split between the landlord and tenant in the same proportion as the crop is shared under the lease. Thus, the question is what effect a so-called flexible cash lease has on the allocation of the government payments between the landlord and the tenant. A flexible cash lease might