Abstract: The purposes of Section 1031(a) (the general nonrecognition provision) and Section 1031(f) (the provision governing related-party exchanges) suggest that a related party’s acquisition of replacement property in anticipation of transferring it to an exchanger should not trigger the operation of Section 1031(f)(4). Nonetheless, related party transactions are subject to close scrutiny under sham transaction, substance-over-form, and anti-abuse doctrines. A District Court’s failure to recognize the distinctions among laws governing such transactions makes the decision a prime candidate for a more enlightened approach by the Eighth Circuit on appeal.

This article examines the purposes and applications of Sections 1031(a) and 1031(f) and reveals that the District Court erred by applying a Section 1031(a) analysis to a transaction that came within Section 1031(f). It illustrates that an exchange should qualify for Section 1031 nonrecognition if a related party acquires property in anticipation of an exchange and transfers it to the exchanger. If the related party or exchanger is a sham entity or if the related party is the exchanger’s agent, however, the transaction may fail to qualify for Section 1031 nonrecognition. Because the District Court failed to appreciate this distinction, its opinion leaves something to be desired.

Introduction

The North Dakota District Court’s holding in North Central Rental & Leasing, LLC v. United States is the third in the line of Section 1031(f)(4) cases, following Ocmulgee Fields and Teruya Brothers, that courts have decided adversely to exchangers who acquired replacement property from related parties. This new case differs significantly from those other cases, however. In Ocmulgee and Teruya, there was no argument or indication that the related party acquired the replacement property in anticipation of its use as replacement property by the exchanger in an exchange. By contrast, in North Central the exchanger stressed, and the court seemed to acknowledge, a link between the related party’s decision to buy from an unrelated
party what would ultimately become the exchanger’s replacement property and the subsequent resale of that same property by that related party to the exchanger.\(^2\) The North Central Court, which merely stated that Teruya and Ocmulgee were “persuasive” and found Section 1031(f)(4) applicable, ignored this crucial distinction.

That is, North Central is a case of first impression. It raised for the first time in a judicial forum whether, as commentators have long contended, Section 1031(f)(4) should be inapplicable if the related party acquired the replacement property in anticipation of transferring it to the exchanger as part of the exchanger’s Section 1031 exchange.\(^3\) The opinion in North Central missed the opportunity to either confirm or reject the understanding that Section 1031(f)(4) does not apply to exchanges if the related party acquires replacement property in anticipation of the exchange, and, if confirmed, to delineate the legal boundaries of the in-anticipation rule, and to explain how parties factually substantiate in-anticipation acquisitions.

Instead, the opinion in North Central seemed to confuse Sections 1031(a) and 1031(f)(4). The North Central court implied that while the exchanger would be entitled to nonrecognition under the general rule of Section 1031(a), the exchanger violated Section 1031(f)(4) because the related party temporarily had dominion over proceeds from the sale of relinquished property. Dominion over exchange proceeds is a section 1031(a) concept, whose application to a related party’s receipt of cash requires a court to apply principles of agency or to disregard one of the entities. With no holding by the court that the related party was an agent of the taxpayer or should be disregarded, the court incorrectly treated the related parties as a single taxpayer and inappropriately applied Section 1031(f)(4).

Following a summary of the findings of fact and holding in North Central, this article reviews the distinctions between Sections 1031(a) and 1031(f). That review illustrates that the two provisions perform very specific functions, and lays the groundwork for analyzing the North Central decision. The analysis reveals that the court and parties to the transaction failed to adequately develop the facts. The insufficient facts led to a confused mixture of Section 1031(a)

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\(^2\) For example, in Ocmulgee, the related party acquired the property more than 9 years before the taxpayer’s exchange. In contrast, the Court in North Central pointed out that when the related party ordered what would ultimately be the exchanger’s replacement property from an unrelated party, such orders were “based on” the exchanger’s forecasts of its equipment needs.

\(^3\) For example, see the 19 year old American Bar Association Tax Section report, “ABA Tax Section Reports on Like-Kind Exchange Issues”, 95 TNT 122 (hereinafter the “ABA Tax Section Report”) (“Q-22. Where a party related to a taxpayer owns no property at the commencement of an exchange, but serves as an intermediary in the exchange, will the application of §1031(f) deny nonrecognition treatment to the exchange because the related party has acquired and transferred property in the exchange as part of its role as intermediary? A-22. No. §1031(f)(2)(C) provides that the rule of §1031(f) will not apply to exchanges between related parties where there is no tax avoidance motive. Use of a related party intermediary does not result in any basis shift or other consequence which §1031(f) is intended to address. However, use of a related party as an intermediary will mean that the exchange falls outside the safe harbor for qualified intermediaries established by Regs. §1.1031(k)-1(g)(4) since a party related for purposes of §1031(f) will be a disqualified person under Regs. §1.1031(k)-1(k). Thus, the taxpayer may bear the burden of proof that the intermediary is not the taxpayer’s agent or that the taxpayer is not otherwise in constructive receipt of proceeds from the sale of the relinquished property’’; Borden, “Recent Developments in Build-to-Suit Exchanges,” 44 BNA Tax Mgt Memo. 19 (2003) (“If a related party acquires property from an unrelated party in contemplation of an exchange, the taxpayer could argue that the property acquired by the related party and any improvements constructed thereon are not subject to §1031(f) because this type of exchange does not involve basis shifting or cashing out’’).
and Section 1031(f) concepts with a mishmash of agency and sham arguments lurking in the shadows. The Eighth Circuit can help rectify the confusion in this area by clarifying the legal boundaries of Section 1031(f) and remanding the case for further findings of fact.

**North Central Rental & Leasing, LLC v. United States**

_North Central_ presents facts that are similar to facts in private rulings that the IRS has issued, but the decision is one of first impression. The parties in _North Central_ stipulated some facts and agreed to limit the scope of the case to two transactions, even though they were part of an exchange program that included numerous transactions on an ongoing basis over several years. The court’s decision is therefore based on the facts of those two transactions.

**Facts**

Butler Machinery Company (Butler) formed North Central Leasing, LLC (North Central) as its subsidiary during 2002.4 Prior to that time, Butler had operated as a dealer and also operated its own leasing division. Deferring gain under Section 1031 was among the reasons that Butler cited for forming North Central.5 Butler was a major dealer of heavy Caterpillar equipment, and North Central leased the same type of equipment. The significant mining and oil exploration and production activity during the times at issue resulted in very significant business for North Central.6

Upon recommendation of Caterpillar, Butler and North Central implemented a like-kind exchange program. As part of the like-kind exchange program, North Central hired Accruit to act as qualified intermediary (QI) and used its software to manage the program. Under Caterpillar’s DRIS financing program, Caterpillar allowed dealers up to six months from the date of purchase

4 Butler owned 99% of North Central, and Dan Butler, the dealer-principal of Butler, owned the other 1%. The facts in _North Central_ are very similar to those in CCA 201013038 (Apr. 2, 2010). In CCA 201013038, the heavy equipment leasing company had its QI use the exchange proceeds to buy equipment apparently already on hand from a related dealer. CCA 201013028 held that Section 1031(f)(4) applied, so the exchange did not qualify for section 1031 nonrecognition. Applying a before-and-after analysis, CCA 201013028 could differ from _North Central_ because at the time the leasing company initiated the disposition of the relinquished property, in CCA 201013028, the dealer had acquired the replacement property without the intent to swap it, while in _North Central_, the dealer, Butler, perhaps acquired the replacement property with the intent to swap it with North Central. Unfortunately, the facts in both CCA 201013038 and _North Central_ are not specific enough to allow for an in-depth critique of the before-and-after analysis the IRS and court applied...” See “Caterpillar Inc. Comments Responding to Notice 2013-13 on Treatment of Dual-Use Property,” BNA TaxCore (7/26/13); Lipton and Gruen, supra note 1.

5 Other reasons for creating North Central offered by Butler purportedly were: (1) to decrease Butler’s liability risk in equipment rental transactions, (2) to create a separate entity of the family business that would allow for a split-off, (3) to facilitate financial lender and tax accounting issues, and (4) to satisfy Caterpillar’s promotion of its dealer Rental Store concept. If Butler had hypothetically owned the 1% LLC membership owned by Dan Butler, however, so that North Central were a single member LLC wholly owned by Butler, most, and perhaps all, of these business advantages could also be achieved. However, under the classification regulations, Reg. 301.7701-3(b)(1), single member LLCs are generally characterized as divisions, whereas two member LLCs are classified as separate entities. Thus, one suspects the primary purpose of placing the 1% LLC interest in Dan Butler was to create a second entity for purposes of Section 1031.

6 During the four years 2004-2007 at issue, there were approximately 400 claimed 1031 transactions, on which North Central deferred about $86 million, or about $200,000 per average transaction. Most transactions consisted of multiple purchases as well as multiple sales. Trial Court stip. 77, paragraph 12, and footnote 2.
of the equipment to pay it for purchases, without interest charges. Caterpillar made the DRIS program financing available to Butler to assist with the like-kind exchange program. Caterpillar promoted the exchange structure by telling dealers that they would be able to take full advantage of the DRIS payment terms and obtain Section 1031 nonrecognition. Butler’s formation of North Central as a separate entity, does not, however, appear to have been a condition for Butler to obtain DRIS financing for its replacement equipment bought from Caterpillar.

Butler carefully studied the recommended like-kind exchange program and the role the DRIS financing would play in the program. As a general matter, North Central would structure its disposition of the relinquished rental equipment and acquisition of the replacement equipment to run through the QI. The QI would receive the proceeds from the disposition of the relinquished property and hold them until directed by North Central to use them to acquire replacement property from Butler or to distribute them to North Central after the expiration of the (g)(6) restrictions. Because North Central and Butler could each acquire replacement equipment directly from Caterpillar on DRIS terms, North Central considered whether Butler or Caterpillar should be the source of its replacement property. If North Central were to acquire replacement property directly from Caterpillar, North Central would then direct the QI to transfer exchange proceeds to Caterpillar. If North Central acquired the replacement property from Butler, North Central would direct the QI to transfer the exchange proceeds to Butler.

If North Central acquired the replacement equipment from Caterpillar, then North Central’s QI would have held exchange proceeds from the date of sale of the relinquished property until the date of payment to Caterpillar. If Butler acquired the replacement equipment directly from Caterpillar, then Butler would receive the exchange proceeds. Butler could use the proceeds for general corporate purposes, from the date of sale of the relinquished property until the date of Butler’s payment to Caterpillar of the purchase price of the replacement property. The court appeared to presume, without specific findings, that Butler had more profitable uses for the funds than the funds could have earned within North Central’s QI, so that Butler’s ability to use the exchange proceeds within Butler, as distinguished from within North Central’s QI, was an economic benefit to Butler. The facts do not specify whether Butler did indeed earn a higher return on the funds than what the QI would have paid.

After studying the like-kind exchange program, Butler decided to form North Central and implement the like-kind exchange program with Butler as the primary source of the replacement equipment. Thus, Butler and North Central structured the transaction to have the QI distribute exchange proceeds in exchange for property that Butler held. Butler paid for the equipment under terms of the DRIS financing. The findings of fact do not indicate how Butler’s situation after receiving the exchange proceeds differed from its situation prior to acquiring the replacement equipment. Also conspicuously missing from the findings of fact was a definitive finding of when the exchange began. The court did not recite any facts that could have been relevant to a determination if and when Butler decided to buy equipment as replacement property.

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7 Of course, the QI could facilitate the exchange without actually taking title to either the relinquished or replacement property. See Reg. 1.1031(k)-1(g)(4)(iv).
8 The QI safe harbor of Reg. 1.1031(k)-1(g)(6)(i) generally prohibits the taxpayer-exchanger from being able to receive the exchange proceeds from the QI before those proceeds are applied by the QI to buy the replacement property.
for like-kind equipment to be disposed of by North Central. Therefore, the findings of fact do not provide sufficient information to find whether Butler acquired the replacement property in anticipation of the exchange.

Holding and Rationale

The court held that Section 1031(f)(4) applied to the transaction, and the North Central transactions did not qualify for Section 1031 nonrecognition. The court reasoned that the transfer of exchange proceeds to Butler, a party related to North Central, was a cashing out because Butler had the unfettered use of exchange proceeds for a period of about six months under the DRIS financing. Butler did not earmark the cash, but it used it in the normal course of business, paying down bank lines of credit, paying the light bill, or making payroll. The court reiterated that “[t]he very essence of an exchange is the transfer of property between owners, while the mark of a sale is the receipt of cash for property.”

The court then used a version of the before-and-after snapshot test to find that the parties had cashed out. Under this before-and-after test, to determine whether there has been a cash-out transaction implicating Section 1031(f), a determination is made as to whether the exchanger and related party, viewed as combined economic unit, has, after the transaction is completed, reduced its property position and equally increased its cash position, as compared to the economic unit’s position before the transaction. In applying this before-and-after test, the court said that before the exchange, Butler held North Central’s replacement property and North Central held the relinquished property. After the exchange, Butler held cash and North Central held the replacement property. Reasoning that both related parties must hold like-kind property after the exchange to have a continuing investment, the court found that the transaction violated Section 1031(f)(4). Despite North Central’s arguments, the court would not consider the transaction to include Butler’s payment to Caterpillar. For the purpose of determining tax avoidance, the boundaries of the transaction in the court’s eyes began at a time when both Butler (holding the replacement property) and North Central (holding the relinquished property) held property and ended when Butler received the cash from the QI.

In other words, the court refused to move back the front end of the transaction earlier in time by taking into account Butler’s cash-property position before Butler’s purchase of the replacement property from Caterpillar. Likewise, the court refused to move the end of the transaction later in time by taking into account Butler’s cash payment to Caterpillar for the replacement property at the end of the six-month DRIS financing period. The court framed the analysis under Section 1031(f)(4), but it relied on Carlton v. United States and Coleman v. Commissioner, two Section 1031(a) cases, to support its conclusion. In Carlton the person claiming Section 1031 nonrecognition arranged for a transaction to close as an exchange, but at closing, the person sold relinquished property to one party, received the sale proceeds, and used

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12 39 AFTR 121, 180 F2d 758 (CA-8, 1950).
them to immediately acquire replacement property. The court recognized that even though the person’s intent was to complete an exchange, the unfettered use of cash, even for a moment, made the transaction a taxable sale followed by a purchase. In Coleman, the person claiming Section 1031 nonrecognition transferred property and received cash and property subject to a mortgage. The person’s intent was to use the cash to pay down the mortgage, but the person could not immediately apply the cash to pay down the mortgage and had the unfettered use of the money until payment. The cash the exchanger received in both cases triggered gain recognition.

The North Central court likened the receipt of cash by Butler (a related party) to the exchanger’s receipt of cash in Coleman. The court did not draw upon established legal concepts, such as the sham-transaction doctrine or agency that would support such a ruling.

Despite relying upon Section 1031(a) authority, the North Central court used Section 1031(f)(4) terminology to find that the parties had structured the series of transactions to lower their tax burden. The court observed that, as an economic unit, North Central and Butler achieved far more advantageous tax consequences with the related party structure than they would have had North Central simply sold the relinquished equipment to a third party. The court also observed that instead of simply selling the relinquished property to a third party, North Central could have transferred the relinquished property to Butler in exchange for the replacement property. If Butler sold the relinquished property within two years after the exchange, the court concluded that Section 1031(f)(1) would have required North Central to recognize gain. The court’s application of this rule is suspect for reasons discussed below.

The North Central court focused on three consequences to hold that North Central and Butler intended to circumvent Section 1031(f). First, the parties cashed in on low-basis property but paid taxes as if they had cashed in on their high-basis property. The court was comfortable with this conclusion because it believed that the parties structured the exchange in a manner that avoided the rules that would apply to a direct exchange between them followed by a cash disposition of one property. Second, Butler received unfettered and unrestrained cash for a period of time, resulting in a cashing out. The court found this troubling because Butler inserted itself in the transaction as the source of the replacement property and received the unrestricted use of cash for up to six months. Third, the court observed that North Central and Butler significantly reduced their immediate taxes by engaging in the exchange. Thus, the court concluded that North Central and Butler constructed the transactions to avoid the purposes of Section 1031(f). Even though the court claimed that the structure was to avoid the purposes of Section 1031(f), it focused on Butler’s, rather than the QI’s ability to earn the yield on the funds during the DRIS finance grace period. The court appeared to be more concerned about that latter point than it was about Section 1031(f). The court also foreclosed the possibility of using an argument based on Section 1031(f)(2)(C) exception for non-tax-avoidance transactions, even though North Central never raised it.

**Section 1031 Jurisprudence**

A full appreciation of the significance of the decision in North Central requires an examination of the jurisprudence of section 1031 and the subtle distinctions between its various subsections. The court in North Central mixed the rules and purposes of Sections 1031(a) and 1031(f) to produce a ruling that deviates from the established legal distinctions of these two
subsections. The court’s failure may stem from a lack of proper factual development in the case but the distinction is critical. A review of the jurisprudence of Section 1031(a) and Section 1031(f) illustrates the different approaches that courts have traditionally taken with respect to these two subsections. It also provides a basis for examining what facts a court must develop to properly apply Section 1031 and help define its boundaries and the boundaries of its various subsections.

Section 1031(a)

Section 1031(a) grants nonrecognition only if a property owner exchanges like-kind property. The central feature of Section 1031(a) is the exchange requirement. A transaction qualifies for nonrecognition under Section 1031(a) only if it comes within the Section 1031 definition of exchange. An exchange is a reciprocal transfer of property. Members of Congress made very clear early on that a transaction qualifies for Section 1031 nonrecognition only if an exchanger does not receive cash as part of the transaction. Statements to that effect came at a time when the definition of exchange and the purpose of like-kind exchanges were in their infancy. One early justification of allowing nonrecognition on the exchange of property was the inability to determine the exchange properties fair market value. Thus, the earliest rules that granted nonrecognition applied only if property did not have readily realized market value. The reference to market value was removed from the statute shortly after the original enactment, and the purpose of Section 1031 was understood thereafter to provide nonrecognition for a continuation of an investment in like-kind property without concern about inability to determine values. The receipt of cash became a marker for discontinuation of the investment in like-kind property. The cases the North Central court cited follow this strict construction of the exchange requirement: if an exchanger receives cash proceeds (either actually or constructively) and has unfettered use of those proceeds, the transaction cannot satisfy the exchange requirement and will not qualify for nonrecognition. Thus, the courts have applied the unfettered-use test to determine whether the exchange has satisfied the exchange requirement.

The court’s focus on Butler’s benefitting from the use of cash suggests that it was distracted by the (g)(6) restrictions in the QI regulations which apply to the QI safe harbor. The QI safe harbor allows an exchanger to complete a multiple-party exchange with considerably less concern about being in actual or constructive receipt of exchange proceeds. If a structure satisfies the requirements of the QI safe harbor, the exchanger will not be in actual or

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13 See Reg. 1.1002-1(d).
14 See 65 Cong. Rec. 2799 (1924).
15 See Revenue Act of 1921, ch. 136, Section 202(c), 42 Stat. 227, 230.
16 See Act of March 4, 1924, ch. 294, 42 Stat. 1560.
18 For an in-depth discussion of history and purpose of Section 1031, see Borden, Tax-Free Like-Kind Exchanges, ¶¶ 1.1-1.3 (2008).
19 See Carlton, 385 F2d 238 (5th Cir. 1967); Halpern, 21 AFTR 2d 1029, 286 F Supp 255 (DC N.D. Ga., 1968). But see Morton, 107 AFTR2d 2011-1963, 98 Fed Cl. 596 (Fed. Cl. Ct., 2011) (holding the momentary access to erroneously withdrawn funds did not cause the exchange requirement to fail because the exchanger’s failure to transfer the funds to the QI would have been conversion).
20 See Reg. 1.1031(k)-1(g)(6).
constructive receipt of the exchange proceeds. The safe harbor includes the (g)(6) restrictions, which require the QI to expressly limit the exchanger’s right to receive, pledge, borrow or otherwise obtain the benefit of the exchange proceeds. The restrictions do not prevent a related party from receiving exchange proceeds, and the exchanger would not be in actual or constructive receipt of exchange proceeds held by the related party, absent a sham finding or the existence of an agency relationship. The restrictions go to the exchange requirement, which is a Section 1031(a) matter, not a Section 1031(f)(4) concern.

Cases like Carlton and Coleman, which the North Central Court relied upon, are Section 1031(a) cases. They consider whether an exchanger actually or constructively receives exchange proceeds. That consideration is necessary to determine whether the exchanger has satisfied the exchange requirement. That Section 1031(a) analysis should be contrasted with a Section 1031(f) analysis, which recognizes the satisfaction of the exchange requirement in the form of an exchange between related parties, but was intended to prohibit basis shifting and cashing out.

Section 1031(f)(4)

The purpose of Section 1031(f) is to prevent basis shifting and cashing out on a direct exchange between related parties. A quintessential prohibited Section 1031(f) transaction arises when a property owner has the opportunity to dispose of low-basis property for cash, and a related party has high-basis property. Instead of disposing of the low-basis property for cash, however, the property owner transfers it to a related party in exchange for the related party’s existing high-basis property. Following the exchange between related parties, the related party sells the formerly low-basis property for cash. Because the related party takes a Section 1031(d) substituted high basis in that property (basis shift), the related party can sell it for cash with little or no taxable gain (cash out).

This example illustrates the elements that must exist for an exchange to come within the purpose of Section 1031(f). First, the party seeking Section 1031 nonrecognition (the exchanger) must hold low-basis property and have the opportunity to dispose of it for cash in a taxable transaction. Second, a party related to the exchanger must hold high-basis property. Third, the exchanger and related party must swap properties and exchange bases of the properties under 1031(d). Fourth, the related party must dispose of the property within two years after the exchange. Fifth, the related party must recognize little or no gain, on the cash sale of the property. In other words, a cash out is a cash disposition that creates a tax benefit for the parties as a result of the Section 1031(d) basis shift.

Snapshots of the situations of the parties prior to and after the transactions help the IRS and the courts determine whether the required elements are present to establish that the transaction comes within Section 1031(f). Prior to a Section 1031(f) prohibited exchange, the exchanger holds low-basis property and has an opportunity to sell it for cash, and the related party holds high-basis property. After the prohibited exchange, the exchanger holds the related party’s high-basis property that has the exchanger’s Section 1031(d) low basis, and the related party holds cash. The existence of an all-property position prior to the transaction and a property-cash position after the transaction, places the transaction with the general prohibition rule of

Section 1031(f). *North Central*, however, was the first to use the snapshot test to find actual or constructive receipt of proceeds.\(^{22}\)

The two-year time period in Section 1031(f)(1) is an arbitrary, although bright-line, rule. Based upon the purpose of Section 1031(f), it seems clear that Congress deemed any transfers that occurred within the two-year period to be prima facie evidence that the parties structured the exchange to affect basis shifting and cashing out. The two-year rule also serves an administrative purpose by relieving the parties of the burden of establishing that the transaction did not have the purpose of shifting basis and cashing out if the cash disposition occurs more than two years after the exchange. To apply Section 1031(f), a court should find that related parties, as an economic unit, were in a property-property position prior to the exchange and in a property-cash position within two years following the exchange. As discussed below, to do so, a court would have to identify when the exchange begins and ends.

Section 1031(f)(4) prevents related parties from using transactions to avoid the purposes of Section 1031(f). For instance, the interposition of a QI into a transaction that would otherwise be a direct exchange between related parties that would result in basis shifting and a subsequent disposition (within two years) resulting in cashing out is a transaction that appears to be structured to avoid the purposes of Section 1031(f).\(^{23}\) One way to test whether a series of transactions is designed to avoid the purposes of Section 1031(f) is to “flatten” the transaction and visualize it as a direct exchange between related parties without the use of a QI. If the flattened transaction as a direct exchange between related parties would come within Section 1031(f)(1), Section 1031(f)(4) should apply and disallow Section 1031 nonrecognition.

Exhibit 1 depicts a multiple-party transaction facilitated by a QI. This is the type of transaction that the IRS and the *Ocmulgee* and *Teruya* courts have found to come within the purview of Section 1031(f)(4) and be subject to the Section 1031(f) prohibition.

\(^{22}\) Compare Teruya Bros., *supra* note 1; Ocmulgee Fields, *supra* note 1; Rushing, 52 TC 888, *aff’d* 27 AFTR2d 71-1139 (CA-5, 1971) (applying the economic unit analysis to a related party installment sale); TAM 200126007.

The transaction in Exhibit 1 is subject to Section 1031(f)(4) because, if it flattened by removing the QI, it becomes a direct exchange that shifts basis under Section 1031(d) and creates a tax-advantaged disposition for cash. Exhibit 2 depicts the flattened, prohibited transaction.

Exhibit 2 is an example of flattening a transaction to determine the true economic arrangement. Exhibits 1 and 2 illustrate how the IRS and courts look through multiple-party related-party exchanges to identify the effect of a transaction. The flattening concept thus provides that if a flattened transaction does not qualify for Section 1031 nonrecognition, the
economic equivalent in the form of a multiple-party related-party QI-facilitated transaction should not qualify for Section 1031 nonrecognition either. The obverse of this concept should also be true: if a multiple-party related-party QI-facilitated transaction qualifies for Section 1031 nonrecognition, then the flattened equivalent of such transaction should also qualify. Furthermore, the flattened equivalent helps explain why certain related-party exchanges qualify for Section 1031 nonrecognition.

The IRS has privately ruled that a multiple-party related-party QI-facilitated transaction qualified for Section 1031 nonrecognition because the related party took a Section 1012 cost basis in the exchanger’s low-basis property, so no basis shifting occurred.24 In that ruling, the related party had cash prior to the exchange and used the cash to acquire the exchanger’s low-basis property from a QI. The related party sold the property within two years after the exchange for cash. Because basis shifting did not occur, Section 1031(f) did not apply to prohibit Section 1031 nonrecognition. Exhibit 3 depicts this IRS-approved transaction.

**Exhibit 3: Allowed Multiple-Party Transaction**

![Diagram of a multiple-party transaction]

Because this transaction qualifies for Section 1031 nonrecognition, the flattened equivalent of this transaction should also qualify for Section 1031 nonrecognition. Instead, the related party first acquires the replacement property from the seller and then transfers it to the exchanger in exchange for the exchanger’s low-basis property. The related party then sells the

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24 Ltr. Rul. 200709036. One commentator recognizes that if a related party sells high-basis property for cash and uses the cash to acquire the exchanger’s relinquished property, this type of transaction could shift basis and result in a cash out. See Cuff, “Some Observations on Related Party Exchanges under Section 1031(f): Part 1,” 9 Business Entities (Jul./Aug. 2007). That it is a worthy observation but it goes more to the question of when an exchange begins and the identification of the parties’ property-cash positions at the beginning of an exchange. If the related party had property at the beginning of an exchange, the before-and-after test would capture that property position. A principal point of this article is that the court must help determine the beginning point of an exchange to enable the application of the before-and-after test. Compare Lipton and Gruen, supra note 1 (seemingly approving Ltr. Rul. 200709036).
formerly low-basis property to the buyer for cash. Exhibit 4 depicts the flattened equivalent of the multiple-party related-party QI-facilitated transaction.

Exhibit 4:
Allowed Flattened Transaction

The flattened transaction in Exhibit 4 is economically equivalent to the multiple-party transactions presented transaction in Exhibit 3. The order of the transactions is not relevant (so long as they occur after the exchange begins) as shown in the discussion that follows. In the flattened transaction, the related party would take a Section 1012 basis in the replacement property because it might pay cash for the property. When the related party exchanged the property with the exchanger, it would take a Section 1031(d) carry-over basis in the exchanger’s low-basis property, equal to the Section 1012 cost basis that it had in the replacement property. The related party takes a Section 1012 cost basis in the exchanger’s low-basis property, so the exchange should not be subject to Section 1031(f).

Indeed, the transaction in Exhibit 4 represents the transaction that qualified for nonrecognition in Fredericks. Even though the transaction in Fredericks occurred prior to the enactment of Section 1031(f), the decision confirms that payment of the exchange proceeds to related party for replacement property is not a violation of the Section 1031(a) exchange requirement. Apparently the Fredericks court recognized that the exchanger and the related party were separate entities for tax purposes and that the related party was not the agent of the exchanger, so the related party’s receipt of the exchange proceeds was not equivalent to the exchanger’s receipt of them. Because the transaction did not raise Section 1031(a) issues, the Fredericks court was not concerned about the related party benefitting from the use of the proceeds from the sale of the relinquished property. A Section 1031(a) analysis focuses on

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25 As discussed in more detail below, if the related party acquires the replacement property to transfer to the exchanger in exchange for property that the related party will sell for cash, the related party should not qualify for Section 1031(d) basis in the property it acquires from the exchanger. Consequently, the transaction most likely cannot create the basis-shifting predicate required to trigger Section 1031(f).
26 TC Memo 1994-27, RIA TC Memo ¶94027.
whether the exchanger actually or constructively receives exchange proceeds. An analysis of the related party’s receipt of exchange proceeds was unwarranted because the exchanger satisfied the exchange requirement by transferring property and receiving property from the related party. The subsequent enactment of Section 1031(f)(4) should not change the result in *Fredericks* because the *Fredericks* transaction does not have basis shifting or cashing out.

**Section 1031(f)(2)(C)**

Very little guidance exists with respect to the Section 1031(f)(2)(C) non-tax-avoidance exception for transactions that would otherwise lose nonrecognition under Section 1031(f). 27 Nonetheless, the general purpose of Section 1031(f) sheds some light on the provision. Because Section 1031(f) exists to prohibit related parties from using Section 1031 to shift basis and cash out, any transaction that does not shift basis or provide for cash out, should not have a prohibited tax avoidance motive. In an earlier article, the authors have discussed several types of transactions that would not shift basis or provide a cash out. 28

This article has discussed another such transaction – the transaction pursuant to which the related party purchases the replacement property from outside the group and holds it in anticipation of transferring it as replacement property in the exchanger’s exchange. Section 1031, where applicable, permits, and indeed requires, that the high basis from replacement property bought from an unrelated person offset the gain on sale of low-basis property to an unrelated person. The abuse at which Section 1031(f) is evidently aimed occurs when high-basis property historically owned by a related party is bought by the exchanger from the related party as replacement property and thus continues to be held in the group. The abuse is that (1) the historically owned property remains within the group, but (2) its relatively high basis offsets cash received by the related party originating from outside the group or overall tax is reduced on the same gain due to the related party’s tax attributes.

The related party’s purchase of replacement property from outside the group and hold it in anticipation of transferring it as replacement property in the exchanger’s exchange should be disregarded as equivalent to the exchanger’s using exchange proceeds to purchase replacement property outside the group. In both such cases, (1) no pre-exchange-owned high-basis property remains within the group; and (2) the related party does not receive cash originating from outside the group, and (3) the related party’s tax attributes are not relevant. Rather, in effect, the related party’s cash purchase price of the replacement property from outside the group is merely replenished with exchange proceeds. There is no abuse because the cash-property positions of the exchangers do not change as a result of the transaction. The *North Central* court apparently failed to grasp this point.

This analysis illustrates that Section 1031(f) does not apply if the related party takes a Section 1012 cost basis in property it acquires from the exchanger (either through the actual

27 The authors have, however, devoted significant thought to this issue. See Alton, Borden and Lederman, *supra* note 10. In Rev. Proc. 2014-3, 2014-1 IRB 111, Section 4.01(43), the IRS announced that it will not ordinarily issue rulings that a related party exchange transaction qualifies for non-recognition by reason of the non-tax-avoidance exceptions in Sections 1031(f)(2)(C) or 1031(f)(4).

transaction or the flattened equivalent). Suppose the related party buys the replacement property with the purpose of exchanging it with the exchanger for the exchanger’s relinquished property, and then selling that relinquished property to an unrelated third party. In this situation, the related party should be viewed as taking a Section 1012 basis in the property acquired for the exchanger for any of three independent reasons: First, the related party does not meet the Section 1031(a)(1) “held for” business or investment purpose with respect to the purchased replacement property, because it holds that property for exchange to the taxpayer, so it could not qualify for a Section 1031(d) exchanged basis. Second, the related party does not meet the Section 1031(a)(1) “held for” requirement with respect to the exchanger’s relinquished property because it acquires the property to sell for cash. Third, even if Section 1031(a)(1) hypothetically applied, the related party’s Section 1031(d) substituted basis equals the related party’s Section 1012 cost basis.

**Analysis of North Central Findings of Fact**

The court’s misdirected attention on Section 1031(a) case law appears to have caused its failure to establish crucial factual details that are necessary for a Section 1031(f) analysis. Perhaps North Central and the government are partly to blame for that shortcoming because they did not fully and clearly present the necessary facts in the stipulations and testimony. To rectify this oversight, the Eighth Circuit should remand the case for further findings of fact. Even the stipulation of facts upon which the opinion is supposed to be based are hazy with respect to crucial matters such as when Butler bought the equipment with respect to the start of the exchange and what role North Central’s demands had on Butler’s decision to buy that equipment.

To apply Section 1031(f), the court must find whether Butler acquired the replacement property in anticipation of the exchange or had it on hand when *North Central* began the exchange. First, the court must find when the exchange began. It may be possible for an exchange, a reverse exchange, to begin before the exchanger disposes of the relinquished property. The IRS acknowledged the possibility of reverse exchanges in the preamble to the Section 1.1031(k)-1 regulations. It also published a safe harbor for structuring parking exchanges to facilitate what are in substance reverse exchanges. Second, the court must find whether the exchanger and related party intended that the related party’s acquisition to be replacement property for the exchanger’s transaction. The court failed to make findings

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29 See Lipton and Gruen, *supra* note 1 (collecting authorities concerning IRS-found violations of the “held for” requirement in the context of exchangers who, pursuant to a pre-arranged plan, acquire property for the purpose of a like-kind exchange or dispose of property acquired in a like-kind exchange).

30 TD 8346 (4/25/91) (with respect to “reverse-Starker transactions . . . the Service will continue to study the applicability of the general rule of [S]ection 1031(a)(1)”). Reverse exchanges enjoy policy, theoretical, and perhaps legal support. See Borden, “Reverse Like-Kind Exchanges: A Principled Approach,” 20 Va. Tax Rev. 659 (2001); Ltr. Rul. 9823045; Ltr. Rul. 9814019. However, practitioners are reluctant to recommend them, in part because some unplanned transactions failed to qualify as reverse exchanges. See, e.g., Bezdjian, 61 AFTR2d 88-1105, 845 F2d 217 (CA-9, 1988).

31 See Rev. Proc. 2000-37, 2000-2 C.B. 308. However, the Rev. Proc. 2000-37 safe harbor is apparently unavailable if the parked property is held, as it was in North Central, by a person who is related to the exchanger. See Lipton, "New Revenue Procedure on Reverse Like-Kind Exchanges Replaces Tax Risk With Tax Certainty," 93 JTAX 327, at footnote 4 (December 2000).
regarding these critical facts, perhaps because the parties failed to present sufficient facts upon which it could make such findings.

North Central made several rather general arguments that suggest the “before” snapshot should be before Butler bought North Central’s replacement property. For instance, it stated that Butler took into account North Central’s projected needs in ordering equipment from Caterpillar, North Central’s manager was experienced in the leasing market, and sample transactions involved Butler ordering specialized mining equipment that would be of particular interest to North Central’s known leasing customers rather than to unknown potential buyers from Butler. Although these facts suggest the related party acquired the property in anticipation of the exchange, they may not be specific enough for such a finding.

On the other hand, some of North Central’s replacement equipment was apparently not so special purpose, such as general purpose forklifts. Moreover, there was no prohibition on Butler reselling to unrelated retail customers equipment that Butler originally bought for North Central, and covering the North Central requirements later from other dealers or Caterpillar. Further, there was apparently no certainty that Butler could perfectly predict, at the time Butler ordered from Caterpillar, the date North Central’s relinquished equipment could be sold, the resale price, and the replacement property then needed. The type of large mining truck in the stipulated facts suggests, however, that North Central had a fairly clear understanding of its future needs and that Butler acquired that truck to transfer to North Central. Unfortunately, the lack of fully developed facts prevents a person reading the case record to definitely determine when the exchange began and whether Butler acquired the equipment as part of the exchange.

There was apparently no formal written evidence created by Butler of Butler’s intent to use a specific item of Caterpillar equipment as replacement property for North Central. Nonetheless, the nature of the large mining trucks that was the replacement property in one of the transactions at issue required a two-year lead time for Caterpillar to construct. Because that large mining truck was ordered by Butler for North Central’s portfolio of leased equipment, North Central undoubtedly communicated with Butler regarding North Central’s desire for Butler to acquire the truck to transfer it as replacement property to North Central. Butler very likely acquired that equipment for the sole purpose of transferring it to North Central, but the findings of fact do not adequately establish that.

North Central also argued that the “after” snapshot should be taken after Butler paid Caterpillar, so that Butler had no more cash at the end than it had at the beginning of the transactions. This focus on the back end of the transaction evidently led to the confusion in the decision. The Court in North Central, however, did not address North Central’s expanded “before” and “after” analysis. Rather, the Court looked immediately after Butler bought the replacement property and before Caterpillar was paid and found Section 1031(f)(4) applicable.\(^{32}\)

\(^{32}\) Another argument North Central argued on brief, but was not addressed by the Court, was that Butler should be viewed as a conduit for North Central’s purchases. But where Butler had the replacement property on hand when North Central sold the relinquished property this argument could lead to the conclusion that the transaction does not even qualify under Section 1031(a) because North Central already bought the replacement property before the sale of the relinquished property. See DeCleene, 115 TC 457 (2000). That put North Central in the position of arguing that Butler was North Central’s conduit for purposes of ignoring Butler’s participation under Section 1031(f)(4), but not North Central’s conduit for purposes of ignoring Butler’s participation under Section 1031(a). Further, if Butler
To properly decide the case, the court needed to analyze the front end of the exchange by determining when it began and establishing what Butler held at that time.

**Analysis of North Central Decision**

The *North Central* decision raises many questions. First, the decision leaves one to ask whether a structure can have a principal tax avoidance motive if the structure increases the likelihood of tax liability. The court held that Butler and North Central structured the exchanges to avoid tax, but the structure appeared to increase the likelihood of audit and tax liability. Second, the possibility that a related party can acquire replacement property in anticipation of an exchange begs the question of when an exchange begins and what parties must do to establish that the related party’s acquisition was in anticipation of the exchange. Third, Butler’s debt-cash position following the receipt of cash may require an analysis of whether the debt-boot rules apply to the before-and-after analysis. Finally, the ruling calls into question whether the court should have applied (or actually did apply) the sham transaction doctrine. Consider these several questions in turn.

**Tax Avoidance**

As the court noted in *North Central*, North Central could have structured the disposition of used equipment and acquisition of replacement equipment in any number of ways. Apparently, the court was convinced that the parties could have conducted the exchanges in a much less complicated manner. Nonetheless, the court appears to accept that North Central had only four alternatives: (1) simply sell the equipment to the third party for cash and recognize taxable gain; (2) do a direct exchange with Butler, followed by a disposition by Butler; (3) acquire the replacement property directly from Caterpillar as part of an exchange that would have qualified for Section 1031 nonrecognition, in which case North Central’s QI and not Butler would hold the exchange proceeds; and (4) use the related party structure it used. Consider each of these structures in greater detail.

As to the first option, Section 1031 specifically allows property owners to structure transactions to avoid that result, so structuring to avoid a direct taxable sale was not problematic. The imposition of otherwise avoidable tax under option 1 left North Central with three other transactions from which to choose.

As to the second option, the court acknowledged that this transaction would qualify for Section 1031 nonrecognition. With this alternative, however, the exchange proceeds would be held by North Central’s QI, and not Butler. Thus, the benefit of the DRIS financing would be limited to the return North Central obtained on funds held by the QI. Moreover, this transaction might not have been possible as a business matter in all cases. For example, it may be that Caterpillar was unwilling to hold a specialized piece of equipment, until North Central was in a position to acquire it as replacement property. Given Caterpillar’s history with Butler and North Central, it seems possible that Caterpillar would accommodate North Central by delaying

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was viewed as North Central’s conduit for purchases, the court might have also been inclined to view Butler’s receipt of the exchange proceeds as constructive receipt by North Central under Section 1031(a).
transfer of title for a reasonable period of time. Consequently, this structure may have been feasible.

As to the third option, there would be no cashing out of historically owned high-basis property within the group because Butler did not historically own North Central’s replacement property. Also, Butler, after paying Caterpillar, would have no net cash inflow. Further, Butler’s basis in North Central’s former property would be determined by Butler’s Section 1012 cost basis. This third alternative should thus preserve Section 1031 nonrecognition and allow Butler, rather than North Central’s QI, to hold the exchange proceeds.

The court’s conclusion begs the question: if a structure results in gain recognition when alternative structures would not have resulted in gain recognition, how could a principal purpose of the chosen structure be tax avoidance? Putting aside the possibility that North Central might have simply sold the property and recognized gain (a result the court recognizes the law does not require), North Central was left to choose from three alternatives, and two of those unchosen alternatives would not have triggered gain recognition. A plan that could trigger gain that would not have been recognized otherwise can hardly be said to be motivated by the intent to avoid the very tax that is imposed and would not have been imposed otherwise. In fact, North Central’s objective of buying through Butler rather than buying directly from Caterpillar appears to have been to enable Butler to make more efficient use of the exchange proceeds than North Central could have achieved through its QI prior to their payment to Caterpillar, and even potentially generate more taxable income through a higher yield on the investment of the exchange proceeds. If that transaction triggers taxation, North Central’s motives appear in part to have been the possible incursion of tax, not tax avoidance. If that is the case, then the decision in North Central is flawed because it relies heavily on its finding that North Central structured the transaction to avoid tax.

The court’s blunder appears to have come from applying Section 1031(a)(1) formalism to Section 1031(f), which normally looks to the economic substance of a transaction. Carlton and Coleman, the two cases that the court cites for constructive receipt, are Section 1031(a)(1) cases, which follow that section’s formalism. By definition, an exchange under Section 1031 is a reciprocal transfer of property, and Carlton indicates that even the momentary access to exchange proceeds spoils an exchange. Courts disregard the form of a related-party exchange to determine if it violates the basis shifting and cashing out prohibitions in Section 1031(f). They do not use it to determine adherence to Section 1031(a). 34

The Beginning and End of an Exchange

North Central also presents the question of the proper boundaries of a Section 1031 exchange. One may question whether the use of exchange proceeds outside the QI for 180 days is even an abuse. One may question whether North Central is consistent with the string of IRS

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33 Reg. § 1.1002-1(d).
34 See, e.g., Biggs, 47 AFTR2d 81-484, 632 F2d 1171 (CA-5, 1980); Coastal Terminals Inc., 12 AFTR2d 5247, 320 F2d 333 (CA-4 1963); Haden Co., 36 AFTR 670, 165 F2d 588 (CA-5, 1948); Mercantile Trust Co., 32 BTA. 82 (1935) (respecting the form of transactions structured solely for tax purposes to find the structure satisfied the exchange requirement).
private rulings that allow serial related-party exchanges to qualify for Section 1031 nonrecognition. These rulings conclude that, due to the absence of a principal tax-avoidance purpose, Section 1031(f) does not deny non-recognition to serial exchanges if the exchange proceeds are paid to a related party’s QI, which subsequently uses that cash to timely acquire like-kind property for that related party.\textsuperscript{35} These private letter rulings rely on legislative history indicating that a second disposition in a non-recognition transaction does not constitute a principal tax avoidance purpose for purposes of Section 1031(f). They further confirm the need for both Section 1031(d) basis shifting, which occurs in serial exchanges, and cashing out, which does not occur here.

The serial exchange rulings appear to suggest that the IRS views Section 1031(f) to have a very limited purpose. In other words, Section 1031(f) was not intended to police all possible abuses of Section 1031. Congress enacted Section 1031(a)(3) to require exchangers to identify and complete transactions within certain prescribed time periods, yet serial exchanges approved by the IRS allow related parties to avoid those time restrictions. That suggests that Section 1031(f) exists for the sole purpose of preventing basis shifting and cashing out. If Section 1031(f) does not apply to related-party exchanges that extend the Section 1031(a)(3) time periods, it should arguably not apply to exchanges that circumvent the Section 1031(a) prohibition of actual or constructive receipt of exchange proceeds. Clearly, Section 1031(f) is not a catch-all provision. In addition to shedding light on the scope of Section 1031(f), the serial-exchange rulings help establish the boundaries of an exchange. Those rulings suggest that related parties can string several exchanges together to extend the identification and exchange periods. Therefore, they address the back end of an exchange, but leave unanswered the possible use of related party structures to extend the front end of an exchange. Identifying the beginning point of an exchange is, of course, critical in applying the before-and-after test. To know a related party’s property-cash position prior to an exchange, a court must establish when an exchange begins.

The \textit{North Central} court missed the opportunity to consider when the North Central exchange began. This failure could result in a decision that has ramifications equivalent to those in the ground-breaking decision in \textit{Starker v. United States}.\textsuperscript{36} The focus in that case, however, was on the back-end delay in acquiring replacement property, with the result that non-simultaneous multi-year exchanges were approved. \textit{North Central}, on the other hand, provides the opportunity to rule on the front-end transfer timing aspects of an exchange. The court could confirm that a related party’s acquisition of property in anticipation of an exchange does not trigger Section 1031(f). The court could also determine whether the exchanger must send a signal to the related party to establish that the related party acquired property in anticipation of an exchange.

Ideally, any guidance on related-party acquisitions in anticipation of exchange would cover several issues. Even if the Eighth Circuit does not provide such guidance, the IRS or even Congress might consider promulgating safe harbors. Such guidance should consider whether related-party acquisitions that occur within a certain time period (say 180 days) prior to an

\textsuperscript{35} See Alton, Borden, and Lederman, "Do Serial Exchangers Get Cash, With Extra Time to Boot, Under New Letter Ruling?" 114 \textit{J\textsc{tax}} 153 (March 2011); Ltr. Ruls. 201220012, 201216007.

\textsuperscript{36} 44 \textit{AFTR} 2d 79-5525, 602 F2d 1341 (CA-9, 1979).
exchange come within a safe harbor that indicates acquisition in anticipation. Timing requirements similar to those found in Rev. Proc. 2000-37 could apply to related party acquisitions in anticipation of an exchange. The safe harbor could provide that for an acquisition to be in anticipation of an exchange, the related party can hold the property for no more than 180 days before transferring it to the exchanger as replacement property, and the parties must identify the property as the exchanger’s replacement property within 45 days after the related party acquires it. The rule could also require the related party to hold the property for sale in order to prevent the related party from taking depreciation deductions with respect to the property and prevent the related party from taking a Section 1031(d) substituted basis in property acquired from the exchanger. Such requirements would prevent the basis shifting and cash-out abuses that Congress prevents with Section 1031(f)(4).

Debt-Boot Rules in Related-Party Exchanges

Although never raised in North Central, one may question whether the transaction there could have been subject to debt-boot rules. Those rules provide that if an exchanger has liability relief, as part of an exchange, the liability relief is treated as cash boot. Liability assumed or cash paid by the exchanger offsets liability relief, but liability assumed does not offset cash received. With appropriate facts, the government could have argued that Butler’s position prior to the exchange was an existing unused line of credit with Caterpillar and after the exchange it was cash plus liability under the line of credit, and the debt-boot rules should apply. With no guidance on this issue, it would be a matter of first impression, and the government would have to overcome the Section 1031(a)-1031(f) distinction to successfully argue the point.

In North Shore Bus Co., the exchanger was allowed to net out a loan which was paid off by the exchanger, after depositing the exchange proceeds in its account with the cash due at closing, but in that case the exchanger’s pay-off check to the lender was written the same day of the exchange. In a private ruling released last year, the IRS treated exchange proceeds “immediately disbursed by QI to satisfy Taxpayer's obligation” on a line of credit secured by the relinquished equipment as not creating taxable cash boot. By contrast, in Coleman, the Eighth Circuit refused to allow an exchanger to net out a long-term, non-prepayable loan, against cash received, in determining taxable boot. Coleman was cited by the District Court in North Central in support of its conclusion that Butler received cash and not like-kind property, notwithstanding that, unlike the liability in Coleman, Butler’s account payable to Caterpillar was short-term and pre-payable.

But, more importantly, Butler was not the exchanger in North Central; rather, it was North Central. Therefore, there was little room for a finding of a Section 1031(b) boot in North Central under the debt-boot rules. Much as the constructive receipt issues should not apply to a

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37 See Section 1031(d); Reg. 1.1031(d)-2.
38 1 TCM 493 (1943), aff’d 32 AFTR 931, 143 F2d 114 (CA-2 1944).
39 See CCA 201325011.
40 39 AFTR 121, 180 F2d 758 (CA-8 1950). See also Barker, 74 TC 555 (1980) (netting allowed for liability extinguished at closing with exchange proceeds pursuant to agreement with acquirer, since exchanger had no dominion and control over the cash); Ltr. Rul. 9853028.
related party’s receipt of cash, the debt-boot rules should not apply to the related party’s receipt of cash.

A Chief Counsel Advice also suggests that a related party’s receipt of cash should not trigger an exchanger’s gain recognition. CCA 201325011, like North Central, addresses program exchanges. In the CCA, the equipment leasing company exchanger’s equipment secured a line of credit used by the leasing company both for its purchases of new equipment and for general business operations. The QI immediately disbursed the exchange proceeds to pay down the leasing company’s line of credit. The IRS ruled that the use of the exchange proceeds to pay down the leasing company’s line of credit did not give the leasing company actual or constructive receipt of those exchange proceeds. This is important because repayment of the line of credit frees the exchanger to draw cash down from the line of credit. Thus, using exchange proceeds to pay down a line of credit is economically equivalent to paying cash to an exchanger.

Failure of (g)(6) Restrictions?

Because the court did not find the requisite basis shifting and cashing out, one possible explanation of its decision is that it found the relationship between Butler and North Central to lack economic substance, to be a sham, or to be an agency relationship. The court did not state this to be the case in its opinion, nor did it apply an analysis to suggest this is what it was thinking. Nonetheless, an examination of the facts and rulings help assess the validity of such arguments. These arguments particularly go to the question of whether the court should consider the violation of the (g)(6) restrictions.

The court focused on the parties’ benefitting from the use of the exchange proceeds. Consequently, an issue North Central raises is whether structuring a transaction to obtain the unfettered use of cash is a tax motivation. The court’s conclusion that it is, flies in the face of existing precedent. In Commissioner v. Indianapolis Power & Light Company, for instance, the Supreme Court explained that the benefit from the unrestricted and unfettered use of loan proceeds for a period of time does not make the proceeds income. The Supreme Court said that tax law contemplates that a person might obtain benefits for holding loan proceeds, and it taxes those benefits. Similarly, even though Butler had the unfettered use of the money it obtained from North Central’s QI for buying its equipment, it was taxed on whatever income could be earned from that money. Thus, the advantage the parties obtained by interposing Butler as the buyer-reseller from Caterpillar, as opposed to having North Central buy the replacement equipment directly from Caterpillar, was that of generating additional taxable income for the group. Structuring a transaction with the purpose of taking maximum advantage of a special financing arrangement that creates additional taxable income should not be viewed as a tax avoidance motive because tax law will subject the pretax income generated by that special arrangement to tax. As stated above, the (g) (6) restrictions are designed to provide clarity and certainty to an exchanger seeking to avoid actual or constructive receipt of proceeds in violation of the exchange requirement.

The District Court was evidently sympathetic, and perhaps even decisively swayed, by the government’s argument that North Central’s interposition of Butler was inconsistent with the (g)(6) restrictions. 42 Those restrictions generally prohibit the taxpayer-exchanger from receiving, or benefitting from, the exchange proceeds prior to reinvestment in replacement property. Although in North Central, the exchanger never received the exchange proceeds, by interposing Butler, the exchanger’s 99% member, Butler did receive and hold the exchange proceeds until Caterpillar was paid. Nonetheless, the entity classification rules provide a bright-line test that clearly recognizes entities separately, even if they have 99% common ownership. To disregard the separate existence of Butler and North Central, the court should have applied some sort of substance-over-form, sham transaction doctrine, agency relationship, or partnership anti-abuse type provision. It did not do any of those.

Viewed another way, suppose Butler had hypothetically been the 100% member, rather than a 99% member, of North Central, so that North Central was viewed as a disregarded entity (a mere division of Butler). Then North Central’s QI’s payment to Butler for the replacement property would have been a payment to the exchanger itself. The court may have understandably felt the 1% membership interest in the North Central by a principal in Butler should not change the result. It did not, however, make that finding.

Since all the equipment transactions considered in the North Central opinion involved only entirely cash payments by the unrelated acquirers to the QI, the effect of taxability to North Central by reason of Section 1031(f)(4) was as a practical matter equivalent to the consequences of finding that North Central violated the (g)(6) restrictions. If, however, North Central’s relinquished equipment had hypothetically been the subject of a part-boot, part-like kind exchange, application of Section 1031(f)(4) could have been far more adverse than a finding of a violation of the (g)(6) restrictions. For example, suppose a trade-in occurred such that that the unrelated acquirer of North Central’s relinquished property transferred directly to North Central like-kind equipment worth somewhat less in value than North Central’s relinquished equipment, and paid to North Central’s QI the remaining amount in cash, which cash was smaller than North Central’s gain. Suppose that the QI paid these exchange proceeds to Butler, to buy additional equipment recently bought by Butler from Caterpillar on credit. If this was violation of the (g)(6) restrictions, the gain would be limited to the boot. By contrast, under the District Court’s Section

42 See the government’s post-trial brief, stating “North Central essentially argues that while [under Reg. 1.1031(k)-1(g)(6)] it can never access the sales proceeds for so much as a second if it wants to defer gain, nevertheless, its parent company and 99% owner (Butler) can access the very same funds to use as it sees fit for up to six months while North Central defers gain.” The government did not argue that Butler receiving the sales proceeds from North Central’s disposition of relinquished equipment created constructive receipt in view of the QI safe harbor. That safe harbor requires, among other things, that the North Central and its QI be no more than 10% related. This IRS failure to argue constructive receipt presumably was because (1) Butler received the exchange proceeds in its capacity as seller of the replacement equipment, not as seller of the relinquished property; and (2) there was no evidence that Butler was an agent for North Central in receiving the exchange proceeds from the QI. The IRS did not argue, however, that having a 1% interest in North Central held by Dan Butler, rather than having all 100% owned by North Central, violated the partnership anti-abuse regulation, Reg. 1.701-2(k), since a principal purpose seems to have been to prevent a cash receipt violation by Butler. Nor did the IRS argue that, because North Central had no separate employees or physical location, that Reg. 1.482-1(f)(1)(iii), which provides that Section 482 overrides Section 1031 nonrecognition in transactions involving commonly controlled organizations when necessary to clearly reflect income. There appears to be no authority discussing Reg. 1.482-1(f)(1)(iii) in connection with related party exchanges.
1031(f)(4) analysis, this temporary investment of even a portion of the sale proceeds could have created recognition of the full gain to North Central. It is doubtful whether Section 1031(f)(4), whose language seems to apply an all-or-nothing approach to the availability of Section 1031 non-recognition, permits an exchange partially for like-kind property and partially for boot to be partially entitled to non-recognition. In other words, Section 1031(f)(4) seems a rather drastic remedy for an arguable violation of the (g)(6) restrictions, though perhaps not in the North Central case itself.

In serial exchange rulings discussed above, the IRS granted non-recognition notwithstanding the fact that the related-party group earns, through the related party’s QI, the economic benefit of investing the yield on the pretax exchange proceeds for a period which can extend far longer than the number of days involved in North Central. Indeed, the IRS has granted non-recognition on sequential serial like-kind exchanges, where the cash from the exchange proceeds is held by QIs whose investment yield will accrue to members of the related-party group for up to 540 days, and it seems quite possible that IRS will allow an even longer period. Viewed differently, these IRS private rulings look to see, at the end of the entire series of related party cash transfers whether or not the initial exchange proceeds create a net cash increase within the related group. If they do not create a net cash increase within the group, these rulings find no tax-avoidance purpose. Unlike North Central, these private rulings do not stop the analysis at any arbitrary point in time, e.g., 179 days after the first disposition, to determine whether or not there has been a net cash increase within the related group. On the other hand, unlike North Central, in these private letter rulings, the exchange proceeds were held by the QIs for the related party group, and not by the members of the related party group themselves. Their utility may therefore answer other questions discussed above.

**Conclusion**

The court evidently was perturbed that merely having a board member of North Central creep into the mechanics of the Caterpillar transaction, by obtaining a 1% membership interest in North Central, could have the effect of insulating North Central from the taxability of North Central’s QI’s pre-reinvestment disbursements to Butler. Nonetheless, the (g)(6) rules prohibiting pre-reinvestment disbursement apply to pre-reinvestment disbursements to the exchanger, not to its 99% parent-member.

The court, was incorrect in finding that such use of the exchange proceeds outside North Central’s QI caused the Caterpillar transfers to metamorphose into Section 1031(f)(4) transactions. Section 1031(f)(4) seems not to be directed to transactions involving replacement property bought from outside the group for the purposes of the exchange, as was the case in North Central. Section 1031(f)(4) does not seem to be the appropriate tool to disqualify that perceived abuse of the (g)(6) restrictions.

The court’s opinion ignores, and thus conflicts with, long-established commentary excluding from Section 1031(f)(4) transactions where the related party buys the relinquished property in anticipation of the exchange. The Eighth Circuit should take this opportunity to

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confirm the existence of an exception from Section 1031(f)(4) for transactions involving replacement property bought from outside the group for the purposes of the exchange.