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Unusual Like-Kind Exchanges

Like-kind exchanges are well-known events in the field of investment real estate. The tax law has spent about the last 30 years refining the deferred like-kind exchange, in which the taxpayer is given time to locate the property it wants to receive for the property it wants to “sell” to a buyer who has no interest in participating in a like-kind exchange; that is why a “qualified intermediary” is the middleman for these exchanges.

But Section 1031 can extend far beyond investment real property, or even operating real property like hotels and apartment buildings. It can extend to whole business swaps and to intangible property swaps.

Comminution

The first requirement for applying Section 1031 to a whole business swap is to comminute the business assets into exchange groups that can be swapped without gain recognition or like-kind groups of property. For example, the real estate and fixtures of a manufacturing plant can be exchanged for another plant, the machinery as a group can be exchanged for other machinery, the rolling stock can be exchanged for other trucks and the patents and other intellectual property can be exchanged for like groups. The only intangible thing that cannot be exchanged is goodwill.

Of course to achieve complete nonrecognition, values must be matched. As that is seldom possible, gain can be recognized to the extent of excess value received.

Intangible Personal Property

In one recent ruling, LTR 201531009, Taxpayer 1 swapped licenses from seven licensors with Taxpayer 2. The licenses were for manufacturing and distribution rights. They differed only in the territories for distribution.

Historically, the IRS has viewed manufacturing rights as different from distribution rights. This ruling was unusual in that it treated them as of like-kind making up one exchange group. The reason was that the rights generally went together in the business.

Related Party Exchanges: Cross-Border

A second ruling, LTR 201027036, illustrates how related parties can use Section 1031. They only need to avoid Section 1031(f), which can make an exchange taxable if either party disposes of the property within two years.

In this ruling, a foreign affiliate leased what sounds like heavy equipment or electronics. At the end of the lease term, it took the property back. Its sister corporation, a U.S. subsidiary of the common U.S. parent, was in the business of reconditioning the used equipment. The taxpayer's problem was how to transfer the used equipment from the foreign subsidiary to the U.S. subsidiary.

Evidently there was unrealized gain in the equipment. The foreign subsidiary would recognize that gain if it either sold the equipment across to the sister, or if it distributed it up to the parent (which might recognize an inbound dividend).

The solution was a like-kind exchange. The taxpayer engaged an unrelated intermediary to buy new equipment from an unrelated seller. The intermediary swapped the new equipment with the foreign subsidiary for the used equipment. Then the intermediary sold the used equipment to the U.S. subsidiary that would recondition it.

Not only did the foreign subsidiary not recognize any gain, it did not generate any foreign base company income and did not generate any earnings and profits.

Conclusion

There are several unusual ways to move property around affiliated groups without gain recognition (Section 355, reorganizations). But Section 1031 is more often overlooked. In both related and unrelated party property dispositions, it should be part of the tax planner's tool kit.

For additional information, call Jack Cummings at 919.862.2302.

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