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Tax Court: Like-kind exchange treatment disallowed, transaction structured to cash out gain

The U.S. Tax Court today issued a memorandum opinion concluding that the taxpayer's gain related to a disposition of real property in 2007 was not entitled to nonrecognition treatment under section 1031(a) because the replacement property was purchased from a wholly owned subsidiary that had sufficient NOLs to fully offset its regular tax liability relating to the sale.

The Tax Court concluded that the transaction was structured to avoid the purposes of section 1031(f), and that the taxpayer was not entitled to defer recognition of the gain realized on the exchange of the property under section 1031(a)(1).

The case is: *Malulani Group, Ltd. v. Commissioner,* T.C. Memo 2016-209 (November 16, 2016). Read the **Tax Court memo opinion** [PDF 87 KB]

Summary

The taxpayer would have had to recognize approximately $1.89 million gain had the property been sold to an unrelated third party. Because the transaction was structured as a like-kind exchange, only the subsidiary reported that it recognized gain of $3.1 million that then was almost entirely offset by net operating losses (NOLs).

The Tax Court held that as a result of structuring the transaction as a deferred exchange, the taxpayer and its subsidiary were able to cash out of the investment in the property almost tax-free. Thus, it was inferred that the transaction was structured with a tax-avoidance purpose.

The Tax Court observed that the transaction at issue was similar to two prior cases in which the deferred exchange between related parties was found to violate section 1031(f)(4)—*Ocmulgee Fields, Inc. v. Commissioner,* 132 T.C. 105 (2009) and *Teruya Bros., Ltd. v. Commissioner,* 124 T.C. 45 (2005).