

tax structure. Should everyone pay the same rate? Or is California's progressive tax rate structure "fair"?

Unfortunately, the provisions of Prop. 63 and California's high personal income tax rates have produced great volatility in the revenues on which California's budget is based. When an economic downturn hits high-income taxpayers (who have seen a substantial reduction in capital gains and stock options in the past few years), California's state budget faces a similar reduction in its revenue base. Based on the most recent data from the Franchise Tax Board, the taxpayers in the top 1 percent of income earners in the state pay 50 percent of the personal income tax revenues. Because this turns into a public policy debate best suited for the elected members of the legislature, no state court is going to enter the fray, and decisions such as this case can be expected.—*C.M.* ♦

## Federal Taxation

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### Like-Kind Exchanges

#### Substance prevails over form in the like-kind exchange arena.

*Teruya Bros., Ltd. v Commissioner* (9th Cir 2009) 580 F3d 1038

*Teruya Brothers* is a rare decision that applies IRC §1031(f)(4) and disallowed like-kind exchange treatment even though the technical requirements were satisfied.

Teruya Brothers, Ltd. (Taxpayer) was a Hawaiian corporation that owned several pieces of real estate known as Ocean Vista and Royal Towers. It also owned 62.5 percent of Times Super Market (Times). Times owned three pieces of real estate known as Kupuohi I, Kupuohi II, and Kaahumanu.

Taxpayer wanted to sell Ocean Vista and Royal Towers, but it had a low basis in these properties. Times had a high basis in its three properties. Taxpayer entered into like-kind exchange agreements to sell Ocean Vista and Royal Towers to unrelated parties through an accommodator, which agreed to acquire like-kind replacement properties to transfer to Taxpayer. The accommodator entered into purchase agreements with Times to buy Kupuohi I, Kupuohi II, and Kaahumanu as replacement properties and transferred these properties to Taxpayer.

After the transactions were completed, Taxpayer had sold Ocean Vista and Royal Towers to unrelated parties; Taxpayer owned Kupuohi I, Kupuohi II, and Kaahumanu; and Times had the cash from the sale of Ocean Vista and Royal Towers. From a tax standpoint, Taxpayer deferred \$1,345,169 of gain on Ocean Vista and \$10,700,878 of gain on Royal Towers. Times recognized a gain of \$1,352,639 on the sale of Kupuohi II, a gain of

\$2,227,040 on the sale of Kaahumanu, and a capital loss of \$6,453,372 on the sale of Kupuohi I. It had a large operating loss for the year and did not recognize the gains. It did not recognize the loss of \$6,453,372 because IRC §267 prohibits the sale of losses from sales between related parties.

The IRS conceded that the transactions would qualify as like-kind exchanges under the general rules of IRC §1031. It also conceded that §1031(f)(1) did not apply; that section generally precludes nonrecognition when a taxpayer engages in a like-kind exchange with a related party and either party disposes of the exchanged property within 2 years. The IRS was forced to resort to the more nebulous §1031(f)(4), which provides that a taxpayer cannot claim nonrecognition for "any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of [§1031(f)]."

The court looked to the legislative history of §1031(f)(1). The House Committee Report stated:

[R]elated parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. . . . The committee believes that if a related-party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment, and the original exchange should not be accorded nonrecognition treatment.

The Ninth Circuit rejected Taxpayer's contention that the economic consequences were irrelevant to its inquiry and that Taxpayer's continued investment in real property determined the case. The court held that often the only way to determine the applicability of §1031(f) is to examine the economic positions of the taxpayer and the related party in the aggregate. Further, the taxpayer and related party should be treated as an economic unit in an inquiry such as the one at hand.

**COMMENT:** The court's resolution of the case is not surprising. Taxpayer was effectively selling real estate to himself and trying to treat it as replacement property for like-kind exchange treatment. Taxpayers and tax practitioners often forget to take into account the substance of a transaction and believe that technical compliance is all that is needed. Taxpayers need to bear in mind that U.S. Supreme Court decisions are law and the Court's decisions that substance prevails over form have been in place and reaffirmed time after time for decades.

The court notes that the tax price to Times from reducing its net operating losses may have equaled or even exceeded the tax deferred by Taxpayer. The court said it did not need to determine whether this would evidence a purpose other than tax avoidance, because Taxpayer did not argue this point.—*M.B.* ♦