TAM 201437012 (9/12/2014). Properties in Program Exchange may be Rematched if First Match is Invalid

The ruling concludes that, in LKE Program transactions under Rev. Proc. 2003-39, if certain properties previously matched as replacement properties are later determined to be ineligible as replacement properties under IRC § 1031, other eligible replacement properties that were timely identified and acquired, but not reported as matched, qualify as replacement properties.

Taxpayer both sells and rents equipment. In the tax year in question, the total cost of the replacement properties exceeded the proceeds from the relinquished properties. Each relinquished property was a separate exchange and the Taxpayer received one replacement property for each exchange. Taxpayer used an automated algorithm to match replacement properties to relinquished properties. This automated algorithm applied a "first-in-first-out" (FIFO) methodology under which the first replacement property identified and received within the prescribed statutory and regulatory timeframes was matched against the relinquished property. The excess replacement properties that were not needed as replacement properties in the LKE Program were capitalized at full cost and amortized as rental equipment.

On audit, the IRS found that some of the replacement properties were not eligible for exchange under IRC § 1031 because they were held primarily for sale rather than primarily for rental. Taxpayer wants to use previously unmatched excess replacement properties to match with the eligible relinquished properties. The unmatched properties were also acquired within the relevant 45-day identification period and are rental properties. Section 4.02 of Rev. Proc. 2003-39 provides that the replacement property must be matched no later than the due date (determined with regard to extensions) of the taxpayer's return. The IRS Examination Team argues that the matching of ineligible replacement properties with the relinquished properties is binding on Taxpayer upon filing of its return, and a later rematch is not permitted.

In response to the IRS Examination Team, the IRS National Office first notes that Section 1031 is not an elective provision. Thus, how a taxpayer reports a transaction on its income tax return does not determine whether § 1031 applies to the transaction. It states that Taxpayer's characterization of the transaction on Form 8824 ("Like-Kind Exchanges") or elsewhere on the income tax return cannot override the application of either § 1031 or the treasury regulations to transactions qualifying as like-kind exchanges. The ruling then states that rematching is appropriate because the unmatched replacement properties were properly identified when they were received by Taxpayer under the LKE Program before the end of the identification period. The ruling finds that nothing in Rev. Proc. 2003-39 contradicts this conclusion.

The ruling states that the concept of "matching" of relinquished properties with replacement properties in Rev. Proc. 2003-39 is primarily to facilitate computation and administration in these large scale LKE Programs. The Rev. Proc. does not mandate any particular procedure for matching replacement properties with relinquished properties. Further, it does not mandate that the matching of replacement properties with relinquished properties at the time of the exchange. It only requires that the match be made by the extended due date of the

taxpayer's return for the year of the exchange. As a safe harbor, Rev. Proc. 2003-39 does not support the conclusion that a taxpayer is bound by its selection of replacement property if that property is later found ineligible and Taxpayer has other eligible replacement property that was not already treated as replacement property in an exchange.

The Examination Team makes several arguments. First, it urges that to allow rematching of replacement properties after the due date of the taxpayer's return is contrary to the intent of Congress when it added § 1031(a)(3) to the Code, limiting the period for identifying and acquiring replacement properties in deferred exchanges. The greater the taxpayer's discretion to vary the particular property to be received in exchange for the relinquished property and to vary the date on which such replacement property (or money) is to be received, the more the transaction is appropriately treated as a sale and not as a like-kind exchange. The National Office responds the facts presented assume the relevant properties are of like kind and the potential replacement properties are received within the 45-day identification period.

Next, the Examination Team cites Bavlev v. Commissioner, 35 T.C. 288, 298 (1960) for the proposition that, for Federal tax purposes, binding elections exist whenever a taxpayer has a free choice between two or more alternatives and communicates that choice to the Commissioner. However, the ruling points out that IRC § 1031 is not elective. Further, the reporting of a match has no bearing on whether a § 1031 exchange took place. Adopting the Examination Team's position would make § 1031 elective by the taxpayer's choice of match.

Finally, the Examination Team raises the concern that to allow rematching after the due date of the return for the year of the exchange in question would place an unworkable administrative burden on the Service in examining exchanges in an LKE Program. If the taxpayer may rematch each time there is a proposed adjustment, the taxpayer's purported exchanges would remain a moving target up until the expiration of the statute of limitations. In addition, aggressive taxpayer behavior would raise concerns about whether the taxpayer was conducting a bona fide mass LKE Program or was actually selling property. The National Office responds that the facts do not show that Taxpayer is conducting a mass LKE Program in bad faith or attempting to outlast the statute of limitations. While there is additional burden on Exam resulting from Taxpayer's ability to rematch property upon determination by Exam that the originally matched replacement property is ineligible, this is an unavoidable burden inherent in a provision of the Code that does not irrevocably bind the taxpayer and the IRS to the position originally reported by the taxpayer on its return.