

MEMORANDUM

TO: Senior Partner
FROM: J.D. Team Number ___22_____
DATE: November 12, 2007
SUBJECT: 2007 Law Student Tax Challenge Problem

I. Introduction

Ronald Frump (“Frump”) is the CEO of Frump International, Inc. (“Frump Inc.”). Frump Inc. has two subsidiaries, Frump Investment Management, Inc. (“FIM”) and Frump Property Management, Inc. Frump desires to form a new business entity (“FSR”) with Hans Sigmund and Franz Royal. Frump wants to exchange one or more properties owned by Frump Inc. for one of two properties in Las Vegas, Nevada: (1) Krustilu Casino (“Krustilu”) or (2) Lot No. 752. The fair market value of Krustilu is \$45 million with a mortgage of \$5 million. Frump’s bank will require Krustilu to be held in a single-asset entity if the Krustilu mortgage is assumed. The list price of Lot No. 752 is \$40 million with no liabilities. Frump intends to contribute the acquired Las Vegas property, along with \$5 million worth of services, to FSR. Additionally, Sigmund and Royal want FSR to dedicate a “wing” to work on preservation efforts for lions and tigers in Africa and the Middle East.

II. Acquisition of the Las Vegas property

Frump should acquire one of the Las Vegas properties in a like-kind exchange under I.R.C. section 1031. Frump should exchange Playland for Krustilu, because these properties will qualify as of like kind and will satisfy the like-kind exchange holding requirements. Before the exchange, Frump Inc. can transfer Playland to FIM tax-free. Frump should also reduce the Playland liability. After the exchange, Krustilu can be transferred to FSR tax-free if FSR is viewed as a partnership for tax purposes. If the owner of Krustilu wants to receive cash rather than Playland, Frump can structure the transaction as a deferred like-kind exchange.

A. General requirements for the like-kind exchange

In general, gain or loss on an exchange of property is recognized. I.R.C. § 1001(c). However, section 1031 provides for exchange of like-kind properties without recognition of gain or loss. To qualify for nonrecognition, an exchange must meet three requirements: (1) property must be exchanged; (2) the taxpayer must hold the relinquished property “for productive use in a trade or business or for investment” before the exchange, and must hold the replacement property for one of the same purposes after the exchange; and (3) the relinquished and replacement properties must be of like kind. § 1031(a)(1).

i. Exchange of property

“Exchange” means a reciprocal transfer of non-cash property. Treas. Reg. § 1.1031(k)-1(a). Such transfer may be direct or through an intermediary. See Treas. Reg. § 1.1031(k)-1(g)(4)(iii). An exchange need not be simultaneous. Treas. Reg. § 1.1031(k)-1(a).

ii. “Held for productive use in a trade or business or for investment”

The phrase “held for productive use in a trade or business or for investment” is not defined in the Code or the Regulations. Frump-del-la-Rey has been held for personal use. Thus, taking the statutory language at its plain meaning, Frump-del-la-Rey cannot be used in a tax-free exchange under section 1031.

A transfer of the relinquished property to FIM before the exchange will be tax-free for the corporate transferor and the wholly-owned corporate transferee. § 351; § 1032. However, a pre-exchange transfer of the relinquished property has a small risk of failing the holding requirement of section 1031. In earlier revenue rulings, the IRS took an unfavorable view of pre-exchange transfers of relinquished property. See Rev. Rul. 75-291, 1975-2 C.B. 332; Rev. Rul. 77-297, 1977-2 C.B. 304; Rev. Rul. 77-337, 1977-2 C.B. 305. However, the Tax Court and the

Ninth Circuit have interpreted the holding requirement more liberally. See Bolker v. Comm’r, 81 T.C. 782 (1983) (holding requirement was met where taxpayer acquired relinquished property in a tax-free transfer before the exchange), aff’d on other grounds, 760 F.2d 1039 (9th Cir. 1985) (holding requirement was met where taxpayer did not intend to liquidate or use relinquished property for personal pursuit); see also Richard M. Lipton, The ‘State of the Art’ in Like-Kind Exchanges, 104 J. TAX’N 138, 153-54 (Mar. 2006). More recently, the IRS has indicated that one entity’s use of relinquished property may be attributed to another related entity for purposes of satisfying the holding requirement. I.R.S. P.L.R. 9751012 (Sept. 15, 1997); see also 104 J. TAX’N at 152.

Here, Frump Inc. has held the yacht club/marina, the office building, the golf dome, and Playland for business purposes. Transfer of one of these properties to FIM will be tax-free and for a business purpose. The IRS should allow business use of the relinquished property by Frump Inc. to be attributed to FIM for purposes of qualifying under section 1031. In any event, under Bolker, the transfer will not violate the holding requirement for relinquished property.

After the exchange, Frump wants to transfer the replacement property to FSR. A post-exchange transfer risks failing the holding requirement for replacement property. The IRS has stated that the holding requirement is violated if a taxpayer transfers the replacement property to a corporate entity in an incorporation transaction. Rev. Rul. 75-292, 1975-2 C.B. 333. However, the Tax Court has held that the holding requirement is satisfied where a taxpayer contributes the replacement property to a partnership. Magneson v. Comm’r, 81 T.C. 767 (1983), aff’d, 753 F.2d 1490 (9th Cir. 1985). The IRS appears to have acquiesced to Magneson. See FSA 199951004 (I.R.S. 1999). Thus, if FSR is treated as a partnership for tax purposes, the IRS should not challenge the like-kind exchange due to the transfer of the replacement property.

iii. Property of like kind

The term “like-kind” refers to “the nature or character of the property,” rather than its “grade or quality.” Treas. Reg. § 1.1031(a)-1(b). State law determines whether property is real or personal. Aquilino v. U.S., 363 U.S. 509, 512-13 (1960). Improved real estate is of a like kind to unimproved real estate. Treas. Reg. § 1.1031(a)-1(b). Personal property must be of the same class to be of like kind. Treas. Reg. § 1.1031(a)-1(b). The IRS has viewed personal property of a hotel/casino complex as including separate general asset classes of 57.0 for the hotel operations and 79.0 for the casino operations. Rev. Proc. 87-56, 1987-2 C.B. 674; see also Rev. Rul. 89-121, 1989-2 C.B. 203 (stating that a section 1031 exchange of one business for another requires an analysis of the underlying assets); FSA 200203009 (I.R.S. 2002). If it is unclear whether real or personal property has been exchanged, the Tax Court has looked to the negotiations of the parties. Beeler v. Comm’r, 73 T.C.M. (CCH) 1982.

The safest exchange of properties is Playland for Krustilu. Assuming that both Playland and Krustilu are real property under their respective state laws, and that the negotiations reflect an exchange of real property, the IRS will likely view Playland and Krustilu as real property, and thus as of like kind. But if the IRS views Playland and Krustilu as comprising both personal and real property, the personal property of the two hotel/casino complexes will be treated as of matching general asset classes, so that the like-kind property requirement will be met.

B. Treatment of liabilities in the like-kind exchange

A liability relinquished in a like-kind exchange may cause recognition of gain. Gain may be recognized to the extent of money or the fair market value of non-like-kind property received. § 1031(b). A relinquished liability is treated as money received. Treas. Reg. § 1.1031(d)-2. A relinquished liability may be offset by a liability assumed. Treas. Reg. § 1.1031(b)-1(c). Here,

Playland carries a liability of \$15 million. Krustilu carries a liability of \$5 million. Thus, an exchange of Playland for Krustilu could cause recognition of up to \$10 million in gain.

To avoid recognition, Frump should reduce the Playland liability before the exchange. The Tax Court has signaled its willingness to allow adjustment of liabilities in anticipation of a like-kind exchange. Garcia v. Comm’r, 80 T.C. 491, 505 (1983) (holding that liabilities incurred on replacement property can be used to offset relinquished liabilities); but see Long v. Comm’r, 77 T.C. 1045, 1080 (1981) (holding that taxpayer could not minimize net liability by reallocating partnership liabilities in anticipation of a like-kind exchange). The Tax Court distinguished the Garcia transaction from the Long transaction on the grounds that whereas Long involved “an artificial attempt to reallocate liabilities for the purpose of tax avoidance,” in Garcia the adjustment of liabilities had “economic substance.” Id. at 505. Garcia did not elaborate, but “economic substance” appears to be satisfied when the taxpayer takes on debt requiring repayment. See id. at 504-506. Although following Garcia the IRS took a negative view of adjustment of liabilities in anticipation of an exchange, more recent private letter rulings indicate a limited willingness to allow liability adjustment. See, e.g., I.R.S. P.L.R. 200019014 (allowing refinancing of properties due to economic significance independent of the exchange); but see, e.g., I.R.S. P.L.R. 8434015 (disallowing netting of liabilities where mortgage on exchanged property appeared to be a “cash-out” which lacked “independent significance”).

Frump could refinance the other properties or issue debt, using the proceeds to pay the liability on Playland. If Frump reduces the Playland liability to zero, Playland and Krustilu will have equal equities, and FIM will not recognize gain due to relinquished liability. Borrowing against other properties or issuing debt should meet Garcia’s economic substance requirement, because the transaction will be negotiated separately from the exchange and will arguably have

independent economic significance. Reducing the Playland liability should also avoid the appearance of “cashing out,” because Frump Inc. will have the same overall debt obligations before and after the adjustment.

C. Deferred like-kind exchange

If the owner of Krustilu wants cash in exchange for Krustilu, the transaction should be structured as a deferred like-kind exchange (“DLKE”) using a qualified intermediary (“QI”). In a DLKE, “the taxpayer transfers property [satisfying the holding requirement] ... and subsequently receives property to be held either for productive use in a trade or business or for investment.” Treas. Reg. § 1.1031(k)-1(a). A deferred exchange must meet two requirements: (1) identification of the replacement property within the identification period, and (2) receipt of the replacement property within the exchange period. Treas. Reg. § 1.1031(k)-1(a), (b).

The Regulations provide safe harbors for DLKEs. Treas. Reg. § 1.1031(k)-1(g). Where the taxpayer transfers relinquished property to a QI, “the taxpayer’s transfer of the relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange.” Treas. Reg. § 1.1031(k)-1(g)(4). A QI is a person, other than the taxpayer or a disqualified person as defined under the Regulations, who enters into a written agreement under which the QI “acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.” Treas. Reg. § 1.1031(k)-1(g)(4)(iii).

To qualify for the QI safe harbor, FIM should enter into a written agreement under which (1) FIM transfers Playland to a QI, (2) the QI sells Playland to a third party, (3) the QI buys Krustilu for \$40 million, and (4) the QI transfers Krustilu to FIM. Thus, the owner of Krustilu

would receive cash, and under the safe harbor, FIM's relinquishment of Playland and receipt of Krustilu will be a tax-free exchange under section 1031.

III. Formation of FSR

FSR should be formed as an LLC electing partnership tax treatment. At a minimum, the LLC agreement should restrict the distribution of any property contributed by FIM. FIM will not recognize gain or loss on the contribution of Krustilu to FSR. Assumption of the Krustilu liability by FSR will lower FIM's basis in its partnership interest. Any contribution of services by Frump on behalf of FIM should be in exchange for a profits interest in FSR.

A. Choice of entity

FSR should be formed as an entity receiving partnership treatment for tax purposes. Partnership treatment is preferable to corporate treatment for the purpose of satisfying the like-kind exchange requirements, particularly if Krustilu is transferred post-exchange to FSR (see *supra* Part II(A)(ii)). Partnership treatment is also preferable because if FSR receives corporate treatment, FIM's contribution of Krustilu to FSR will not meet the requirements for a tax-free contribution under § 351. Additionally, partnership treatment is preferable if FSR wants to contribute to Sigmund and Royal's preservation activities abroad (see *infra* Part IV).

To receive partnership treatment, FSR can be a general partnership, a limited partnership, a limited liability partnership, or a limited liability company electing partnership treatment. The best choice of entity for FSR is an LLC, which offers a flexible membership agreement and limited liability for members.

B. LLC agreement provisions

At a minimum, the LLC agreement should restrict the distribution of property contributed by FIM. If partnership property is distributed within seven years of contribution, then the

contributing partner recognizes gain or loss as if the property had been sold at its fair market value at the time of distribution. § 704(c)(1)(B)(i). Specifically, the LLC agreement should state that any property contributed by FIM cannot be distributed without FIM's consent or at least until seven years and one day after contribution.

C. Capitalization of FSR

i. Contribution of property

After Krustilu is acquired by FIM, Frump will want to contribute Krustilu to FSR in exchange for a partnership interest. “No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” § 721(a). The “disguised sale” rule of section 707(a)(2)(B) does not apply here, because the exchange is of property for a partnership interest. Thus, there will be no recognition of gain or loss on the contribution.

If FSR assumes the Krustilu liability, then the partners' bases in their respective partnership interests must be adjusted. The basis of FIM's interest in FSR will be decreased by the portion of the liability that is allocated to Sigmund and Royal. § 752(b); § 733. The basis of Sigmund and Royal's interest in FSR will be increased by the portion of the liability that is allocated to them. § 752(a); § 722.

ii. Contribution of services

Frump wants to contribute services in exchange for part of FIM's partnership interest in FSR. Section 721 does not apply to the contribution of services in exchange for a capital interest. Treas. Reg. § 1.721-1(b)(1). A capital interest is defined as “an interest in the assets of the partnership, which is distributable to the owner ... upon his withdrawal from the partnership or upon liquidation.” Treas. Reg. § 1.701-1(e)(1)(v). “The mere right to participate in the

earnings and profits of a partnership is not a capital interest in the partnership.” Id. A capital interest received in exchange for services is included in income under section 61 in an amount equal to the interest’s fair market value. Treas. Reg. § 1.721-1(b)(1); § 83.

A contribution of services in exchange for a profits interest may be tax-free. Rev. Proc. 93-27, 1993-2 C.B. 343; see also Rev. Proc. 2001-43, 2001-2 C.B. 191. A profits interest is an interest in future profits and appreciation only. Rev. Proc. 93-27, 1993-2 C.B. 343. A contribution of services will be taxed if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as high-quality debt securities, or (2) the partner disposes of the profits interest within two years of its receipt. Id. Thus, to avoid taxation Frump should contribute services on behalf of FIM in exchange for a profits interest, to be held by FIM for at least two years.

IV. Activities for the preservation of lions and tigers

Sigmund and Royal want to dedicate a “wing” of FSR to activities for the preservation of lions and tigers in Africa and the Middle East. These preservation activities should not be conducted within FSR. Section 170 provides for donor deductions of qualifying charitable contributions. “Charitable contribution” includes a contribution or gift to or for the use of a corporation, trust, fund, or foundation organized and operated exclusively for charitable, scientific, or educational purposes, or for the prevention of cruelty to animals. § 170(c)(2)(B). Here, the preservation of lions and tigers fits within the statutorily allowed charitable purposes. But if the preservation activities are conducted within FSR, donors will not be able to deduct contributions under section 170, because FSR will operate primarily as a business.

If a separate section 501 charitable entity is formed, Frump Inc. or other corporate donors should be able to deduct contributions which are used within the U.S. or any of its possessions.

§ 170(c)(2). The IRS has established guidelines for “conduit” cases involving non-corporate contributions to a domestic charity sending money abroad. See Rev. Rul. 63-252, 1963-2 C.B. 101; Rev. Rul. 66-79, 1966-1 C.B. 48. The IRS has stated “that contributions by an individual to a domestic charity, formed to deal with the problem of plant and wild-life ecology in a foreign country through programs that include grants to foreign organizations and over which it maintains control and responsibility, are deductible as charitable contributions.” Rev. Rul. 75-65, 1975-1 C.B. 79; see also I.R.S. P.L.R. 9118012. Thus, contributions by FSR should be deductible so long as Sigmund and Royal’s charity maintains control and responsibility over use of the contributions abroad.

V. Conclusion

FIM should exchange Playland for Krustilu in a like-kind transaction under section 1031. Before the exchange, Frump Inc. can transfer Playland tax-free to FIM. Frump should reduce the liability on Playland, preferably to zero. If the owner of Krustilu wants to receive cash, FIM can structure a deferred like-kind exchange using a qualified intermediary. After the exchange, FIM can contribute Krustilu tax-free to FSR, a newly formed LLC electing partnership tax treatment. Any services contributed to FSR by Frump on behalf of FIM should be for a profits interest in FSR. Sigmund and Royal’s preservation efforts should be conducted in a separate charitable entity, rather than in FSR.

Client,
Tax Town, ABA State, 10000
Subject: 2007 Law Student Tax Challenge Problem
Date: November 12, 2007

Dear Mr. Frump:

Based on the information provided to us, you should be able to acquire the Las Vegas property tax-free, and should be able to form and capitalize FSR with minimally adverse tax consequences. Sigmund and Royal's preservation efforts should not be conducted through FSR. These conclusions are expressly conditioned upon the accuracy of the facts as represented to us and upon the adherence of all relevant parties to the legal advice contained herein.

Scope of representation

We represent Frump International, Inc. (hereinafter Frump Inc.), its subsidiaries, and you in your capacity as CEO of Frump Inc. in assessing the tax consequences of the acquisition of the Las Vegas property and the formation and capitalization of FSR. We do not represent Sigmund and Royal, and we recommend that Sigmund and Royal retain separate representation.

Acquisition of the Las Vegas property

The Las Vegas property should be acquired in a tax-free transaction known as a like-kind exchange. From a tax perspective, the best exchange would be Playland for Krustilu. Frump-del-la-Rey cannot be exchanged because it has been held by you for personal use. The Internal Revenue Service (IRS) could successfully challenge an exchange involving any of the following properties: Lot No. 752, the yacht club/marina, the office building, or the golf dome. We believe that the IRS could not successfully challenge an exchange of Playland for Krustilu. As a precautionary measure, we recommend that you and the owner of Krustilu explicitly negotiate for an exchange of real estate.

A pre-exchange transfer of Playland to Frump Investment Management, Inc. (FIM) before the exchange will be tax-free, but will carry a small risk of disqualifying the subsequent exchange from tax-free treatment under the like-kind rules. Because Playland has been held by Frump Inc. for business use since at least the mid-1990s, and because FIM is a wholly-owned subsidiary of Frump Inc., we believe that the risk of an IRS challenge is low. Transferring Playland to FIM sooner rather than later will reduce this risk.

We recommend that you reduce the liability on Playland. Without any adjustment, the current liabilities on Playland and Krustilu will cause recognition of gain up to \$10 million. Reducing the Playland liability to zero will equalize the Playland and Krustilu equities, and will cause non-recognition of gain in the exchange. The Playland liability could be reduced with proceeds from issuing debt or borrowing against Frump Inc.'s other properties.

If the owner of Krustilu prefers to receive cash, the transaction can still be structured as a tax-free like-kind exchange. Instead of a simple like-kind exchange, FIM would engage in what is called a deferred like-kind exchange. In this transaction, FIM would first transfer Playland to a "qualified intermediary." The intermediary would then sell Playland and use the proceeds to buy Krustilu. Finally, the intermediary would transfer Krustilu to FIM.

For the deferred like-kind exchange to work, the qualified intermediary cannot be FIM's agent, including anyone who has acted as FIM's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within two years before the transfer of Playland. The intermediary also cannot be a person related to FIM, as defined under IRS Regulations. The intermediary may be a party who has performed services for FIM with respect to the exchange in question, or may be a financial institution, title insurance company, or escrow company which has provided routine services to FIM.

The deferred like-kind exchange transaction must be executed within two time constraints. A replacement property must be identified within 45 days of the relinquishment of Playland. Assuming that you accept our recommendations, the replacement property (Krustilu) has already been identified. More critical here is the requirement that FIM receives Krustilu by the earlier of two dates: (1) 180 days after FIM transfers Playland, or (2) the due date for FIM's or its consolidated group's tax return. Before Playland is transferred, you must be certain that the entire transaction can be completed within the exchange period.

Due to the critical importance of complying with these restrictions, we recommend that you seek our advice in selecting a qualified intermediary and preparing for the transaction.

Formation of FSR

FSR should be formed as an entity treated as a partnership for tax purposes. If FSR receives corporate tax treatment, FIM's contribution of Krustilu to FSR would cause recognition. If FSR receives partnership treatment, FIM can contribute Krustilu tax-free.

We recommend forming FSR as an LLC. While several business entities allow partnership treatment under tax law, only the LLC form insulates its members from personal liability from business debt and obligations, including tort liability. To ensure a properly drafted agreement, we would like to have more information on your plans and goals for participation in FSR. At a minimum, the membership agreement should provide that any property contributed by FIM cannot be distributed to another member without FIM's written approval, or at least until seven years and one day after contribution. This provision will protect FIM against unexpected recognition of gain.

If FSR is an LLC electing partnership treatment, FIM's contribution of Krustilu will be tax-free. If FIM takes on the Krustilu liability, FIM's contribution of Krustilu will cause FIM to

have a lower basis in its FSR interest than if the liability were not assumed. To avoid taxation, contribution of services to FSR should be exchanged for an interest in FSR's future profits and appreciation only, to be held for at least two years.

Activities for the preservation of lions and tigers

Sigmund and Royal's preservation efforts should not be conducted through FSR. Sigmund and Royal should seek the assistance of legal counsel to form a separate charitable entity in conformance with applicable state and federal laws. If the charitable entity maintains control and responsibility over its activities abroad, contributions by FSR should be deductible regardless of where the contribution is actually used (here or abroad). Contributions by Frump Inc. or any of its corporate subsidiaries to the charity should be earmarked specifically for use in the U.S. or one of its possessions.

To the extent this message contains tax advice, the U.S. Treasury Department requires us to inform you that any advice in this letter is not intended or written by our firm to be used, and cannot be used by any taxpayer, for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code. Advice from our firm relating to Federal tax matters may not be used in promoting, marketing or recommending any entity, investment plan or arrangement to any taxpayer.

Please feel free to contact us if you have any questions or concerns. We would be happy to provide further explanation of the foregoing advice.

Sincerely,

J.D. TEAM NUMBER ____22____