

# Internal Revenue Service

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CC:ITA:05

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Date:

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## LEGEND:

Trust =

Decedent =

\$X =

\$Y =

Year A =

X Beneficiaries =

Date A =

Date B =

Date C =

Date D =

State A =

State B =

x percent =

Y percent =

z percent =

LLC =

Agency M =

Converted Property =

Dear :

This is in response to your request for a private letter ruling dated September 14, 2004, submitted by your authorized representatives, regarding the application of section 1033 of the Internal Revenue Code of 1986 to a certain property transaction. Specifically, you requested a ruling that the termination of a testamentary trust, followed by a

distribution to an In-Kind beneficiary of certain replacement property acquired after an involuntary conversion of trust property, will not preclude the replacement property from being held for productive use in a trade or business or for investment within the meaning of section 1033(g) of the Code.

## FACTS

The information submitted indicates that the Taxpayer is a private testamentary trust ("Trust") established by Decedent upon his death in Year A to administer his assets. Decedent's will provided for the establishment of the Trust in order to provide an ongoing source of safe and certain income to its beneficiaries, which included Decedent's wife and daughters. Under the terms of Decedent's will, the Trust will terminate at midnight on Date A, which is twenty years after the death of Decedent's last surviving child. Because the Trust is due to terminate in the foreseeable future, the trustees of the Trust ("Trustees") formulated a detailed plan of termination ("Termination Plan"), which outlines a plan and mechanism for the distribution of the Trust's assets to its remainder beneficiaries upon its termination. Trust presently has X beneficiaries. Trust is required to distribute all of its income currently, may not make any other distributions to charitable or other beneficiaries, and is taxed as a "simple trust" under section 651.

Originally, the assets of the Trust consisted mainly of real estate holdings in State A. The submission indicates that, in order to diversify the Trust's real estate holdings, increase investment returns, and generate income, the Trustees received approval from the State A probate court many years ago to conduct exchanges of real estate. The Trustees have engaged in many such exchanges, which have been structured to qualify for nonrecognition treatment under section 1031 of the Code. Trust intends to continue to enhance its investment operations by strategically exchanging certain assets in its portfolio. As a result, the assets in the Trust now include developed and undeveloped real estate holdings in State A and diversified industrial, office, and retail properties located in other states. The Taxpayer's submission represents that all of the Trust's directly-owned properties are held for investment purposes, and that the value of the Trust's assets approximate \$X.

Under the Termination Plan, approximately x percent of the Trust will be distributed on termination in cash to certain remainder beneficiaries. Y percent of the Trust's net asset value, a *de minimus* percentage, will be distributed on termination through an in-kind distribution of one or more Trust properties to one expected remainderperson (the "In-Kind Beneficiary"). The remaining corpus (approximately z percent) of the Trust's net asset value will be contributed by the Trustees prior to termination to an LLC, a to-be-formed State B limited liability company, with the Trust as the single member holding all of the shares in the LLC. All of the shares in LLC will then be distributed upon termination by the Trust among the remainder beneficiaries (to the extent their remainder interest is not otherwise satisfied with cash or in-kind property). LLC is intended to continue the Trust's real estate investment operations in a manner consistent with past practices. It is expected that much of the current managerial and

operational structure will remain in place after the Trust terminates. The Trustees submitted the Termination Plan to State A probate court, which approved it on Date B.

Under the Termination Plan, the In-Kind Beneficiary may designate to the Trustees specific property which might be distributed to him upon termination of the Trust in respect of his remainder interest, including “like-kind” exchange or involuntary conversion replacement real property satisfying the Trust’s investment criteria which the Trust might acquire. With respect to such replacement property, the Trustees, in the exercise of their sole discretion, may elect or elect not to acquire any specifically recommended replacement property, as they may determine to be in the best interests of the Trust, and may dispose of any designated replacement property actually acquired at any time prior to the Trust’s termination. Despite the input and involvement of the In-Kind Beneficiary, it is represented that the Trustees will continue at all times to retain complete discretion over property acquisitions as well as any final property distributions upon termination, subject to State A probate court approval. (We note that under the laws of State A, non-pro rata trust distributions are permitted, and that we have previously determined by private letter ruling that neither the Trust nor its beneficiaries, including the In-Kind Beneficiary, will realize gain or loss as a result of the non-pro rata termination distributions to be made by the Trust under the Termination Plan.)

The Trust was notified on Date C by Agency M, a department or activity of the United States government, that certain of its real estate holdings in State A would be condemned (the Converted Property). The Trust and Agency M have agreed to the general terms of the condemnation, on Date D, for an agreed-upon value of \$Y.

The Trust intends to acquire replacement property suitable to qualify the condemnation proceeds for non-recognition of gain treatment under section 1033(g) of the Code, which property both satisfies the Trust’s general investment criteria and is acceptable for distribution to the In-Kind Beneficiary. It is represented that the replacement property will be of “like-kind” to the Converted Property within the contemplation of section 1033(g), and that the Trust intends to hold the replacement property for investment until the Trust’s termination.

## LAW & ANALYSIS

Section 1033(a)(2)(A) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money, and, during the period specified in section 1033(a)(2)(B), the taxpayer purchases property similar or related in service or use to the converted property, at the election of the taxpayer, gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property.

Section 1033(g) of the Code provides a special rule relating to the condemnation of real property held for productive use in trade or business or for investment. Section 1033(g)(1) provides that, for purposes of section 1033(a), if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

Section 1.1033(g)-1(a) of the Income Tax Regulations provides that the principles relevant in determining whether replacement property is property "of like kind" are those contained in section 1.1031(a)-1 of the regulations. Under section 1.1031(a)-1(b), "real property" is generally considered to be of like kind to all other real property, whether or not any of the real property involved is improved; on the other hand, section 1.1033(a)-2(c)(9)(i) of the regulations provides that improved and unimproved real estate is generally not regarded as similar or related in service or use.

The provisions of section 1033(g) of the Code, like those of section 1031 (relating to exchanges of property held for productive use or investment) require that qualifying replacement property be acquired "to be held" either for productive use in trade or business or for investment, in order for the non-recognition benefits of the statute to apply. Thus, the provisions generally do not apply where a taxpayer intends upon the acquisition of replacement property to subsequently sell or transfer the property to a third party.

For example, in Rev. Rul. 75-292, 1975-2 C.B. 333, an individual taxpayer in a prearranged transaction transferred land and buildings used in the taxpayer's trade or business to an unrelated corporation in exchange for land and an office building owned by the corporation and used in its trade or business. Immediately thereafter, the individual taxpayer transferred the land and office building to the individual's newly created corporation in exchange for the stock of the same corporation in a transaction that qualified for nonrecognition of gain under section 351. The revenue ruling concluded that the individual taxpayer did not exchange the real estate for other real estate to be held either for productive use in a trade or business or for investment by that taxpayer. Instead, the ruling concluded that the replacement property was acquired by the individual taxpayer for the purpose of transferring it to the new corporation in exchange for stock pursuant to section 351. As a result, the ruling held that, as to that individual taxpayer, the exchange did not qualify for nonrecognition (under section 1031).

Similarly, in Rev. Rul. 77-337, 1977-2 C.B. 305, an individual taxpayer owned all of the stock of a corporation. In a prearranged plan, the individual taxpayer liquidated the corporation and transferred the corporation's sole asset, a shopping center, to a third party in exchange for like-kind property. Rev. Rul. 77-337 noted that under Rev. Rul. 75-292, a newly created corporation's eventual productive use of property in its trade or

business is not attributable to its sole shareholder. Rev. Rul. 77-337 thus concluded that the transaction between the individual taxpayer and the third party was a prearranged plan whereby the corporation was liquidated to facilitate the further exchange between the individual taxpayer and the third party of their respective properties. Consequently, the individual taxpayer did not hold the shopping center for use in a trade or business or for investment because the corporation's previous trade or business use could not be attributed to its sole shareholder. Therefore, the exchange did not qualify for nonrecognition of gain or loss (under section 1031).

In Wagensen v. Commissioner, 74 T.C. 653 (1980), pertaining in part to an exchange of real property (a ranch) for like-kind property followed by a gift of the newly acquired ranch property to the taxpayer's children, the court found that the exchange qualified under section 1031. The ranch properties in question were determined to be held for use in a trade or business or for investment by the taxpayer both before and after the exchange.

The Trust has represented that it intends to hold the replacement property for investment purposes until the Trust terminates by its own terms on Date A. The termination of the Trust is not a prearranged plan of the Trustees: the subject Trust is a testamentary trust, the termination date of which was fixed by the Decedent and cannot be modified or changed by the Trustees. Thus, the Trust is not acquiring the replacement property in order to dispose of it to third parties pursuant to an independent plan of the Trustees, but rather to hold until eventual distribution in accordance with the plan of the Decedent. The termination of the Trust on Date A will take effect without regard to whether like-kind exchanges, involuntary conversions, or the replacement of specific Trust assets occur. Trust assets on hand on Date A will be distributed in accordance with the Termination Plan, including in-kind distributions to any then In-Kind beneficiaries. Consequently, the involuntary conversion and attendant acquisition of replacement property considered in this ruling request is wholly independent from the distribution of Trust property that will occur upon the Trust's termination, and materially distinguishable from and outside the contemplation of the circumstances addressed in Rev. Rul. 75-292 and Rev. Rul. 77-337, cited above.

Similarly, the limited involvement of Trust beneficiaries, including the In-Kind Beneficiary, in the identification and selection of replacement property will, under the circumstances described, have no bearing on the determination of whether such property is held for productive use in trade or business or for investment by the Trust under section 1033(g). The Trustees have represented that any replacement property will be held for investment purposes under the Trust's general investment criteria until termination. Moreover, despite any possible earmarking of specific assets for potential in-kind distribution, the Trustees will exercise complete discretion and exclusive authority in the selection of replacement property, as well as in the final distribution of Trust assets upon termination (subject to State A probate court approval). (We note too that, under the approved Termination Plan, the Trustees are required to identify suitable specific Trust property for distribution to the In-Kind Beneficiary.)

## CONCLUSION

Based on the facts and representations presented above, because the acquisition of the replacement property by this Trust is independent of the Trust's pending termination and its distribution of the replacement property to the In-Kind Beneficiary, we rule that such termination and distribution will not preclude the replacement property from being held by the Trust for productive use in a trade or business or for investment within the meaning of section 1033(g) of the Code. Consequently, under section 1033(g), such replacement property will be treated as similar or related in service or use to the Converted Property.

No determination is made by this ruling letter as to whether the described transaction otherwise qualifies for non-recognition of gain under section 1033 of the Code. Further, we express no opinion, except as specifically ruled above, as to the federal income tax treatment of the transaction under any other provisions of the Code and regulations that may be applicable or under any other general principles of federal income taxation. Neither is any opinion expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction(s) that are not specifically covered by the above ruling.

No rulings have been requested or are provided relating to the factual questions of whether any specific replacement property is of "like kind" to the property involuntarily converted, or whether any specific property, converted or replacement, was or is held for a particular purpose.

This letter ruling is based on facts and representations provided by the Taxpayer and its authorized representatives, and is limited to the matters specifically addressed.

A copy of this letter ruling should be attached to any federal income tax return of the Trust reporting details of the subject involuntary conversion pursuant to section 1.1033(a)-2(c)(2) of the regulations. Additionally, because it could help resolve federal tax issues, a copy of this letter should be maintained with the Trust's permanent records.

Pursuant to a power of attorney currently on file with this office, copies of this letter ruling are being sent to your authorized representatives.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the

Internal Revenue Code provides that it may not be used or cited as precedent.

Sincerely yours,  
/s/ Roy A. Hirschhorn  
By: Roy A. Hirschhorn  
Assistant Branch Chief, Branch 5  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

Enclosures:

Copy of this letter  
Copy for section 6110 purposes