Related Party Transactions and LKE Programs:
***North Central Rental and Leasing v. U.S.* on appeal in the Eighth Circuit**

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When a company is in the business of leasing equipment, such as cars, trucks, airplanes, and even cell phones, the property that it owns and leases out qualifies for 1031 exchange treatment. It is important to the business owner to take advantage of the opportunity to exchange, principally in order to avoid having to recapture depreciation. However, it would be cumbersome and expensive to work out a separate exchange for each item of equipment that is sold. Therefore, Revenue Procedure 2003-39 permits taxpayers to set up a single ongoing exchange for leased equipment through a Qualified Intermediary. When old equipment is sold, the proceeds go into a revolving exchange account. New like-kind rental equipment is matched up with appropriate relinquished properties, and it is acquired using exchange funds plus outside funds when necessary. The entire process is monitored and reconciled in consolidated books maintained by the taxpayer and Qualified Intermediary. Because it is an ongoing process, each transaction can be handled at a fraction of the cost, in money and effort, required to handle a stand-alone transaction. This type of exchange is called an “LKE program”.

Facts and Findings

North Central Rental & Leasing, LLC ex rel. Butler v. United States, *2015 WL 855725*, (U.S.C.A. 8th Cir., March 2, 2015) concerns an LKE program involving two related parties. Butler Machinery Company (“Butler”) is a dealer of Caterpillar trucks and other heavy equipment. Until 2002, Butler sold, rented and leased this equipment. In 2002, Butler moved its equipment rental and leasing business to a newly created company, North Central Rental & Leasing LLC (“North Central”), owned 99% by Butler, and 1% by Butler’s principal owner. Butler alleged a variety of non-tax reasons for transferring its rental and leasing business to the new company. Neither the trial court nor the appellate court found those non-tax reasons to be convincing. Instead, the trial court concluded and the appellate court affirmed that the transfer of the rental and leasing business to North Central was structured in an attempt to allow North Central to benefit from an LKE program while Butler impermissibly benefited on the same transactions from 180-day interest-free financing that Caterpillar provides to its dealers.

As North Central’s LKE program was structured, when equipment reached the end of its useful life for rental and leasing purposes, it was sold by North Central through its q]Qualified Intermediary (“QI”) to a third-party purchaser. The proceeds were paid into North Central’s LKE program exchange account. Replacement equipment was purchased by Butler from Caterpillar at North Central’s direction. That equipment was then sold at cost by Butler to North Central. As a Caterpillar dealer, Butler does not have to pay for this equipment for 180 days, but the QI paid Butler for that equipment as soon as it was delivered to North Central. Therefore, in effect, Butler had a 180-day interest free loan on each transaction. If North Central bought the same equipment directly from Caterpillar, a 180-day interest-free loan from Caterpillar would do North Central very little good because North Central would not have access to the exchange funds held by its QI. By purchasing replacement equipment from Butler, North Central had tried to justify the immediate release of those funds to North Central’s parent company.

The IRS attacked this LKE program on two basic grounds: First, this strategy amounted to "… a transaction (or series of transactions) [prohibited under *IRC § 1031(f)(4)*] structured to avoid the purposes…" of subsection (f)'s 2-year holding requirement for property acquired in related party transactions. Second, this LKE program was structured inappropriately to allow North Central/Butler to cash-out on its investment in equipment.

At trial, North Central argued that its LKE program did not constitute a related party transaction because it was exchanging through a QI and not directly with Butler, its related party. The trial court rejected that argument, citing *Teruya Bros., Ltd. v. C.I.R., 580 F.3d 1038, 1046 (11th Cir. 2009)* and *Ocmulgee Fields, Inc. v. C.I.R., 613 F.3d 1360, 1364 (11th Cir. 2010)*. Both of those cases held that IRC § 1031(f)(4)'s language that "[t]his section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection," means that exchanges accomplished through Qualified Intermediaries will be treated like direct related party exchanges when they have essentially the same effect.

North Central argued that, even if its LKE program is considered to be a related party transaction, both Butler and North Central should still be exempt from the 2-year holding period on their replacement properties because *IRC § 1031(f)(2)(C)* exempts transactions from that 2-year restriction if, "…it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax." The trial court rejected this argument for two separate reasons. First, this strategy allowed North Central/Butler to cash-out on its investment in equipment in a manner that would have been either impossible or taxable if it had been carried out directly by North Central. Second, the transaction had the prohibited effect of basis-shifting between North Central and Butler because North Central attempted to exchange its low-basis old equipment without recognizing gain, while Butler sold its high basis new equipment realizing no gain.

Viewpoint

It is the opinion of this writer that the first of these arguments made by the trial court is valid, although it could have been more fully stated, while the second argument is not valid.

Concerning the first argument – that the parties were trying to get six months free use of money in a manner that would have incurred tax recognition if accomplished directly – that might be called "tax avoidance." However, that explanation does not fully dispose of North Central's argument that the purpose of the structure of this transaction was not principally to inappropriately avoid taxes, but rather to get use of Caterpillar's money – a non-tax purpose.

The reason articulated by Congress for the adoption of *IRC § 1031(f)* was to discourage basis-shifting, but the courts have already recognized that this is not the only tax strategy that *IRC § 1031(f)* can be used to discourage. In *Teruya Bros., supra*, the structure employed by the taxpayer and struck down by the IRS and the courts was not intended to take advantage of basis-shifting. Rather, it was intended to take advantage of recognizing profits in one company that had substantial net operating losses that could offset profits from the sale of the relinquished property. That objective could not have been accomplished in *Teruya* without a related party exchange.

I would suggest that the strategy of having North Central's equipment purchased through Butler may have been employed in order to circumvent the *Treas. Reg. 1.1031(k)-1(g)(6)* restrictions on the use of exchange funds while an exchange was pending. In general, as soon as the (g)(6) restrictions do not apply, gain is recognized. Therefore, attempting to circumvent those restrictions would be considered tax avoidance.

As to the second of the court's arguments, that there was in fact basis-shifting, it is the opinion of this writer that this rationale does not justify the outcome. Butler was inserted as a party in this exchange *not* in order to accomplish any basis-shifting. The same property could have been acquired by North Central at the same price directly from Caterpillar. Rather, the transaction should stand or fall on the issue of whether it was proper for North Central and Butler, related parties acting jointly, to obtain 180-days' use of Caterpillar's credit while pocketing cash from the sale of the relinquished property.

In the appellate court's analysis of the case, a great deal of weight was placed on the fact that either the QI or Butler was an unnecessary party to the transaction. North Central could have exchanged directly with Butler without going through a QI, but it did not do so because that would have constituted a direct related party exchange. Alternatively, North Central could have conducted its LKE program through a QI while acquiring equipment directly from Caterpillar. It did not do so because that would not have resulted in a 180-day interest free loan. The LKE program was therefore a "step transaction" (although that phrase was not used by the court). Steps were inserted solely in an attempt to make possible what would -- for federal tax reasons -- have been impossible to accomplish directly.

The court also made it clear that its review of the facts in the case was limited to the question of whether the trial court's findings of fact constituted "clear error." The appellate court did not expressly find that the purpose of North Central's LKE program structure was tax avoidance. Rather, it found only that it was reasonable for the trial court to do so.