

Internal Revenue Service

Department of the Treasury

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Refer Reply To:

CC:ITA:3 – PLR-109215-00

Date:

July 1, 2002

LEGEND:

Parent =

Subsidiary =

Taxpayer =

QI =

Bank =

Administrator =

A =

B =

Lease Program 1 =

Lease Program 2 =

Dear :

This letter responds to your request for a private letter ruling submitted on behalf of Taxpayer, requesting a ruling that the transfers of vehicles described below are deferred exchanges qualifying for nonrecognition of gain or loss under section 1031 of the Internal Revenue Code.

FACTS

Taxpayer is a wholly-owned subsidiary of Subsidiary. Subsidiary is owned by Parent, a multi-state bank holding company. Taxpayer uses the overall accrual method of accounting for maintaining its accounting books and filing its federal income tax return, and uses an annual accounting period that ends on December 31.

Taxpayer is primarily engaged in the business of leasing vehicles to consumers and issuing loans to consumers for the purchase of vehicles. Taxpayer currently maintains a portfolio of vehicles leased to customers. These vehicles are automobiles, passenger vans, light duty trucks, and sport utility vehicles (“SUVs”). Typically the leases range from twenty-four months to sixty-six months in duration. Taxpayer has legal title to each vehicle and depreciates each vehicle pursuant to section 168.

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Taxpayer restructured its vehicle leasing operations with the intention that the disposition of a vehicle coming off lease (a relinquished vehicle) by Taxpayer to an unrelated party and the acquisition by Taxpayer of a vehicle recently leased from a dealer (a replacement vehicle) will qualify as a like-kind exchange under section 1031. Relinquished vehicles are typically sold to the dealer, the lessee, or a third party through an auction. Replacement vehicles are usually purchased from a member of Taxpayer's dealer network.

To meet the requirements of section 1031, Taxpayer entered into an agreement with QI, under which QI is to act as the qualified intermediary under section 1.1031(k)-1(g)(4) of the Income Tax Regulations. Accordingly, Taxpayer assigns its rights for the sale of relinquished vehicles and the purchase of replacement vehicles to QI.

QI is a limited liability company wholly owned by Bank, which is unrelated to Taxpayer. QI retained Administrator, an unrelated third party, to perform certain administrative duties. Under this arrangement, Administrator records the assignments made to QI on the sale of relinquished vehicles and the purchase of replacement vehicles. Administrator also reviews the requests made for the purchase of replacement vehicles and may authorize payments to be made if the requests are for the purchase of vehicles. Taxpayer does not have any contractual relationship with Administrator. Neither Bank nor QI has performed services, other than routine financial services, for Taxpayer or any party related to Taxpayer.

QI maintains three types of accounts for Taxpayer: two Funding Accounts, two Disbursement Accounts, and an Investment Account. From time to time, QI may establish a Supplemental Account for the depositing of additional funds by Taxpayer in the event there are not enough funds in the other accounts to purchase vehicles.

The Funding Accounts hold amounts received by QI from the sale of relinquished vehicles. Such amounts are either received directly via (i) automated clearing house ("ACH") transfers, (ii) personal checks, or (iii) cashier's checks. Payments made by check are first mailed to Taxpayer for verification that the check is made payable in the proper amount to QI. The verified checks are then forwarded to QI for deposit into one of the Funding Accounts. The funds held in the Funding Accounts are not invested by QI unless Taxpayer instructs QI to transfer amounts from the Funding Accounts to the Investment Account. At the election of Taxpayer, amounts in the Investment Account are invested either in A or B.

All amounts expended by QI in the acquisition of vehicles are funded by disbursements directly from the Disbursement Accounts. The funds in these accounts result from the transfer of funds first from the Funding Accounts, then from the Investment Account and finally from the Supplemental Account.

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If the dealer is to be paid via check, Taxpayer writes the check on the appropriate Disbursement Account. Pursuant to the Exchange Agreement, Taxpayer is permitted to write checks on the account solely for the purchase of replacement vehicles and non-replacement vehicles. As confirmation that the checks written during a particular day were for the purchase of replacement vehicles or non-replacement vehicles, Taxpayer must transmit a daily report to QI listing the dealers to be paid by check, the amounts of the checks, and the identification of the related vehicles to be purchased. Upon receipt of this report, QI authorizes payment of the checks and acknowledges its approval by signing the report and faxing a copy back to Taxpayer for its records. If the dealer is to be paid via ACH transfer, Taxpayer instructs QI to execute an ACH transfer to the dealer from the appropriate Disbursement Account.

The Exchange Agreement expressly limits Taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by QI before the end of the exchange period. For this purpose, the exchange period begins on the day of the sale of the relinquished vehicle and ends at midnight on the earlier of the 180th day following the sale of the relinquished vehicle or the due date (determined with extension) for Taxpayer's tax return for the taxable year in which the transfer of relinquished property occurs. The Exchange Agreement provides that Taxpayer has a right to receive money or other property held by QI prior to the end of the exchange period only upon the occurrence of an event described in section 1.1031(k)-1(g)(6)(ii) or (iii).

The Exchange Agreement authorizes QI to purchase all leased vehicles on Taxpayer's behalf, including vehicles that will not be replacement vehicles for purposes of a like-kind exchange. Non-replacement vehicles are purchased by QI and paid for out of the Disbursement Accounts in the same procedures applicable to replacement vehicle purchases. This is done because Taxpayer currently acquires more vehicles than are being relinquished and it matches each replacement vehicle with one relinquished vehicle for basis tracking purposes. The unmatched vehicles are non-replacement vehicles.

Sale of Relinquished Vehicles

The actual exchange transactions take place as described in the following paragraphs. Taxpayer's portfolio of leased vehicles includes three automobiles ("Vehicle A", "Vehicle B" and "Vehicle C"). The sale of each of those vehicles commences when, approximately 180 days prior to the termination of their leases, the lessees receive a letter (the "Option Letter") from Taxpayer detailing the lessee's options at the end of the lease term. Such options include relinquishing possession of the vehicle to Taxpayer, or purchasing the vehicle from Taxpayer. The Option Letter notifies the lessees to contact their Taxpayer representative in order to discuss the end of term options.

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Vehicle A

The lessee of Vehicle A decides to purchase Vehicle A from Taxpayer using funds borrowed from Taxpayer. Taxpayer documents the payoff quote in a letter (the "Payoff Letter") mailed to the lessee. The Payoff Letter documents the sales price, provides a payoff voucher to accompany the payment, and specifies that the payoff should be made payable to QI and mailed to Taxpayer for verification. The Payoff Letter also notifies the purchaser that Taxpayer's rights to sell Vehicle A are assigned to QI.

At the end of the day on which the lessee obtains the payoff quote, Taxpayer produces a report documenting all payoff quotes provided during that day, ("Payoff List") including the payoff quote for Vehicle A. Taxpayer notifies QI of all payoff quotes provided that day by faxing the Payoff List to QI at the end of the business day. The Payoff List includes the name of the lessee, the payoff amount, and the description of Vehicle A. The Payoff List also includes notification to QI that Taxpayer's rights to sell the vehicles listed in the statement are assigned to QI.

To complete the sale transaction of Vehicle A, the lessee forwards to Taxpayer a check, made payable to QI, which Taxpayer, after verifying the amount, forwards to QI, for deposit into the appropriate Funding Account. Upon indication from QI that the lessee's check clears, Taxpayer arranges for transfer of title to the lessee.

Vehicle B

The lessee of Vehicle B decides not to acquire the leased vehicle. Before the lease ends, the dealer who originally arranged the lease purchases the vehicle. The dealer contacts Taxpayer to obtain a payoff quote. Taxpayer documents the payoff quote in a Payoff Letter faxed to the dealer, and, in addition, Vehicle B is included on the Payoff List provided to QI. The notifications described above with respect to Vehicle A are similarly provided to the dealer and QI with respect to Vehicle B. The dealer sends a check, payable to QI. Taxpayer verifies the amount and forwards the check to QI for deposit in the appropriate Funding Account. Upon indication from QI that the dealer's check has cleared, Taxpayer arranges for transfer of title to the dealer.

Vehicle C

The lessee of Vehicle C decides not to acquire the vehicle, and the dealer does not want to purchase it. The lessee returns the vehicle to Taxpayer. Taxpayer determines that Vehicle C will be sold through an auction, and notifies QI of this by faxing it a pending sales report, which lists Vehicle C and its expected sales price. In addition, this report includes language notifying QI that Taxpayer's rights to sell the

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vehicle have been assigned to QI. When the auction takes place, the auction house, which has authority to execute a transfer of title on behalf of Taxpayer, attaches to the title a statement notifying the purchaser that Taxpayer's rights to sell Vehicle C are assigned to QI. After the sale, the auction house transmits the sales proceeds via ACH directly to QI for deposit in the appropriate Funding Account.

Acquisition of Replacement Vehicles

To acquire replacement vehicles, Taxpayer purchases the following three vehicles: a passenger van ("Vehicle D"), an SUV ("Vehicle E"), a light duty truck ("Vehicle F"). In addition to the above three vehicles, a fourth vehicle, an automobile ("Vehicle G") is purchased through QI, using the same methods used to purchase Vehicles D, E, and F. These vehicles are acquired pursuant to contracts Taxpayer has entered into with unrelated dealerships, in which Taxpayer agrees to purchase from the dealer each vehicle leased by the dealer to the lessee under certain terms and conditions.

Vehicles D and E are acquired under Taxpayer's Lease Program 1, while Vehicles F and G are acquired under Taxpayer's Lease Program 2. Under the Lease Program 1, the dealer has the lessee complete a credit application form. Next, the dealer faxes this application to Taxpayer, for review and approval. If approved, Taxpayer faxes to the dealer a credit approval form, which includes an assignment of rights to QI.

Under the Lease Program 2, the selling dealer in each case has the prospective lessee complete the credit application form, and obtains a credit report on the prospective lessee from an external credit bureau. If the lessee's credit is approved, the lessee is eligible for the Lease Program 2. In such a case, the selling dealer completes a form that includes an assignment of rights to QI. Within 2-3 days of executing the lease contract with the lessee, the dealer delivers the relevant documents to Taxpayer for processing. Upon receipt of the documents, Taxpayer confirms approval of the lease and faxes to QI and the dealer a copy of the credit approval form. This document includes language to confirm notification to QI and the dealer that Taxpayer's right to purchase the vehicle was assigned to QI.

After the necessary paperwork has been completed by all parties to the transaction, payment for replacement vehicles can occur in one of two ways. Taxpayer orders QI to transfer funds via ACH from a Disbursement Account to the bank account of the selling dealer. Or, Taxpayer writes a check to the selling dealer, drawn on the appropriate Disbursement Account. If a check is written, Taxpayer must notify QI of the check so that QI can authorize payment of the check pursuant to the Exchange Agreement. This

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notification usually occurs at the end of the day, when Taxpayer transmits a list of all checks written on each Disbursement Account during that day.

In the month following the transaction, Taxpayer generates a report that matches the vehicles, indicating that (i) Vehicle D was the replacement vehicle for Vehicle A, (ii) Vehicle E was the replacement vehicle for Vehicle B, (iii) Vehicle F was the replacement vehicle for Vehicle C and (iv) Vehicle G was not a replacement vehicle.

REQUESTED RULING

The transfers of Vehicles A, B, and C, followed by the acquisition of Vehicles D, E, and F are deferred exchanges of Vehicle A for Vehicle D, Vehicle B for Vehicle E, and Vehicle C for Vehicle F, each qualifying for nonrecognition of gain or loss under section 1031.

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that in general, no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1.1031(k)-1(a) of the regulations provides that a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the “relinquished property”) and subsequently receives property to be held either for productive use in a trade or business or for investment (the “replacement property”). In order to constitute a deferred exchange, the transaction must be an exchange (i.e. a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of section 1.1031(k)-1 are satisfied.

The relevant qualified use of the property owned by Taxpayer and subsequently being exchanged in the transaction is the leasing of such property to third parties. Thus, the relinquished property that Taxpayer previously leased to third parties and the replacement property that Taxpayer will be leasing to third parties upon acquisition is considered property held for productive use in a trade or business in Taxpayer’s hands.

Section 1.1031(a)-1(a) provides that as used in section 1031(a), the words “like kind” have reference to the nature or character of the property and not to its grade or

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quality. One kind or class of property may not, under that Code section, be exchanged for property of a different kind or class. As examples, section 1.1031(a)-1(c) provides that “a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose” are like kind.

Section 1.1031(a)-2(b) further provides as a safe harbor that depreciable tangible properties are of like class if they are either within the same General Asset Class, as defined in section 1.1031(a)-2(b)(2), or within the same Product Class, as defined in section 1.1031(a)-2(b)(3). Taxpayer states that the vehicles exchanged are not within these General Asset Class or Product Class safe harbors.

The General Asset Class and Product Class safe harbors in the regulations simplify the determination of whether depreciable tangible personal property is of a like kind, but they are not the exclusive method for making this determination. For depreciable tangible personal property to be considered of like kind, the property can be either like kind or like class. Section 1.1031(a)-2(a) of the regulations provides that “an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class.” Thus, two properties can be in different General Asset Classes (and thus not be of a like class) and yet be of like kind.

The like-kind property standard has been interpreted more narrowly in the case of exchanges of personal property as compared to exchanges of real property. See California Federal Life Insurance Co. v. Commissioner, 680 F.2d 85, 87 (9th Cir. 1982). Even within the more restrictive parameters of the like-kind standard as applied to personal property, the differences between an automobile (Vehicles A and B) and a passenger van (Vehicle D) or an SUV (Vehicle E) do not rise to the level of a difference in nature or character but are merely a difference in grade or quality and, thus, are like kind property. However, a truck (Vehicle F) is different in nature or character than an automobile (Vehicle C) and, thus, are not like kind property.

Section 1031(a)(3) states that any property received by the taxpayer shall be treated as property that is not like-kind property if (a) such property is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (b) such property is received after the earlier of (i) the day that is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange or (ii) the due date (determined with regard to extension) for transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs. Section 1.1031(k)-1(c) provides that any replacement property that is received by the taxpayer before the end of

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the identification period will in all events be treated as identified before the end of the identification period.

In all cases, Taxpayer acquires the replacement property within the time period mandated by section 1031(a)(3).

Section 1.1031(k)-1(f)(1) provides that a transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. Section 1.1031(k)-1(f)(1) further provides that if the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

Section 1.1031(k)-1(f)(2) provides that except as provided in paragraph (g) of this section (relating to safe harbors), the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. Section 1.1031(k)-1(f)(2) further explains that the taxpayer is in actual receipt of the money at the time the taxpayer actually receives the money or receives the economic benefit of the money. The taxpayer is in constructive receipt of money or property at the time the money or other property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.

Section 1.1031(k)-1(g)(1) provides that there are four safe harbors, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money for purposes of section 1031.

Section 1.1031(k)-1(g)(4) provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether taxpayer is in actual or constructive receipt of money before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

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However, section 1.1031(k)-1(g)(4) only applies if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary, as provided in paragraph (g)(6) of this section.

Section 1.1031(k)-1(g)(4) further provides that a qualified intermediary is a person who is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and enters into a written agreement with the taxpayer (the "exchange agreement") and acquires the relinquished property from the taxpayer, transfers he relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(5) of the regulations provides that the determination of whether the taxpayer is in actual or constructive receipt of money or other property is made without regard to whether or not the taxpayer is entitled to receive any interest or growth factor with respect to the exchange, provided that the taxpayer's rights to receive such interest or growth factor are limited.

Section 1.1031(k)-1(g)(6) provides that an agreement limits a taxpayer's rights as provided in the paragraph (g)(6) only if the agreement provides that the taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

Section 1.1031(k)-1(k)(1) provides that for purposes of this section, a disqualified person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Section 1.1031(k)-1(k)(2) provides that a person is a disqualified person if the person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph, performance of the following services will not be taken into account –

- (i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under § 1031; and
- (ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

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QI is a limited liability company owned by Bank, an unrelated third party. QI and Bank have not previously performed services other than routine financial services for Taxpayer. As such, QI is not a “disqualified person” under the regulations.

Taxpayer has assigned to QI its rights to sell the relinquished property. In all instances, the purchaser receives written notice of the assignment prior to the time that the relinquished property is transferred to the purchaser. Title to the property will be transferred from Taxpayer to the purchaser of the property pursuant to the agreement between Taxpayer and purchaser. Thus, QI will be treated as acquiring and transferring the relinquished property.

In addition, Taxpayer assigned its right to purchase replacement property to QI. In all instances, the seller receives written notice prior to the time that the replacement property is transferred to Taxpayer. Title to the property is transferred to Taxpayer. Thus, QI will be treated as acquiring and transferring the replacement property. Accordingly, QI, acting in accordance with the Exchange Agreement, will be treated as a qualified intermediary and will be treated as acquiring and transferring each relinquished property and each replacement property.

The Exchange Agreement provides that Taxpayer will have no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property as required by the regulations. Proceeds from the sale of relinquished property are deposited into the appropriate Funding Account. To the extent that funds from the sale of the relinquished property are insufficient to cover the purchase of replacement property, QI establishes the Supplemental Account in which Taxpayer deposits funds to cover the amount of the purchases.

Taxpayer is not in actual or constructive receipt of checks written by purchasers of relinquished property. All agreements governing the flow of funds limit Taxpayer’s ability to actually or constructively receive those funds.

Taxpayer is not in actual or constructive receipt of proceeds from the sale or exchange of property when Taxpayer directs the investment of funds in the investment account. The determination of whether the taxpayer is in actual or constructive receipt of money or other property is made without regard to whether or not the taxpayer is entitled to receive any interest or growth factor with respect to the exchange because Taxpayer’s rights to receive such interest or growth factor are limited.

Taxpayer is not in actual or constructive receipt of proceeds from the sale or exchange of property when Taxpayer writes checks for the purchase of replacement property. The Exchange Agreement provides that payment on all checks written on the Disbursement Accounts must be approved by QI.

CONCLUSION

Accordingly, based on your representations and the above analysis, we rule that:

The transfers of Vehicles A and B followed by the acquisition of Vehicles D and E are deferred exchanges of Vehicle A for Vehicle D and Vehicle B for Vehicle E, each qualifying for nonrecognition of gain or loss under section 1031.

CAVEATS

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Robert M. Casey
Senior Technician Reviewer
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)

cc:

Cc: