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State Tax Acceleration of Like-Kind Exchanges: New Hampshire's Position

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The New Hampshire Department of Revenue Administration has recently sought to invalidate some IRC section 1031 like-kind exchanges for New Hampshire business profits tax (BPT) purposes. The department's audit initiative has gained momentum as the number of audits has increased substantially over the last year and the amounts at issue are often significant.[1]

Despite opposition from the business and real estate communities, the department remains committed to its position and has proposed a settlement resolution that would apply to all affected taxpayers in lieu of litigation. The department has proposed to accept payment of an amount equal to 100 percent of the tax the department believes is due in a "failed" section 1031 exchange to settle these cases but effectively to abate interest and penalties. We believe that the department's legal position in these cases is erroneous and that this "settlement" proposal should be rejected by most if not all taxpayers.

This article summarizes the types of transactions affected, the department's position, the authors' position, and the merits of the current settlement proposal.

[1]On June 15, the department for the first time publicly addressed the like-kind exchange issue in examining potential revenue proposals as part of state budget negotiations. The department indicated that it intends to address the like-kind exchange issue in a rulemaking procedure. The fact that the department believes rules are needed to clarify the meaning of the statute may expose the department to litigation risk for pending cases because New Hampshire law requires construing ambigious tax statutes against the state. see *In re Denman*, 419 A2d 1084 (N.H. 1980).

Affected Transactions: Section 1031 Exchanges Through Disregarded Entities

The department has sought to invalidate those like-kind exchanges in which the taxpayer that acquires the replacement property is a different business organization than the taxpayer that sells the relinquished property.[2] That factual scenario often arises in situations in which a federally disregarded entity, usually a single-member limited liability company (SMLLC), is formed by the selling company to acquire the replacement property. Commercial lenders often require use of a SMLLC as a condition to finance the transaction and protect the lender's interests.

Accordingly, a typical New Hampshire audited transaction resembles the following:

- Company A[3] sells New Hampshire real estate (the relinquished property) to a third party either directly or through a qualified intermediary (QI).
- Company A identifies out-of-state replacement property within the required timelines under IRC section 1031 and accompanying regulations (the replacement property).[4]
- Company A's third-party lender requires it to acquire the replacement property through a SMLLC wholly owned by Company A for the purpose of protecting the lender's interests in the transaction.

[2]As discussed below, this is usually a disregarded entity for federal tax purposes. The department asserts that the separate "business organization" treatment for New Hampshire tax purposes invalidates the exchange.

[3]Company A may be any form of organization, including a C corporation, S corporation, or partnership (including a limited partnership or limited liability company).

[4]Technically, and as the department acknowledges, the replacement property's location is irrelevant to the section 1031 analysis. Unsurprisingly, the department appears to be particularly aggressive with out-of-state replacement properties, suggesting that the department's actions are designed not only to accelerate gain but also to defend against perceived leakage from the tax base.

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- Either directly or through the QI, the SMLLC takes title to the replacement property within the timeline and requirements set forth in IRC section 1031 and accompanying regulations.
- The foregoing transactions result in deferral of gain recognition as a like-kind exchange for federal income tax purposes pursuant to IRC section 1031.

The department, however, takes the position that the valid like-kind exchange for federal purposes fails for New Hampshire BPT purposes merely because of the insertion of the SMLCC in the transaction. This audit position exposes the taxpayer to significant BPT exposure, one that could be avoided by having Company A acquire the replacement property directly, but an that approach is often at odds with the lender's requirements.

Department's Position: Different Entity, No Deferral

The BPT's computational starting point is gross business profits, which is defined generally as the amount of taxable income as would be determinable under the provisions of the U.S. Internal Revenue Code. N.H. Rev. Stat. Ann. (RSA) section 77-A:1, III.[5] Despite this federal conformity provision, the BPT differs from most other state business income tax regimes because the BPT is imposed on each "business organization" at the entity level, including disregarded SMLLCs, partnerships, and sole proprietorships, unless specifically treated otherwise in the BPT statute. RSA section 77-A:1, I.[6]

> ***The department believes that the separate business organization treatment trumps the federal conformity provision.***

The department has used this separate business organization treatment as the basis for denying like-kind exchange treatment. Specifically, the department takes the position that like-kind exchange treatment cannot apply for purposes of the BPT — despite the fact that Company A reports no gain from the transaction for federal tax purposes — because the business organization that acquired the replacement property (the SMLLC) is a different business organization than the one that sold the relinquished property (Company A). Stated another way, the department believes that the separate business organization treatment trumps the federal conformity provision. As a result, even though the exchange qualifies for section 1031 treatment for federal income tax purposes, the department invalidates the section 1031 transaction for BPT purposes and taxes the gain in the year that the section 1031 transaction fails (for state purposes).

Authors' Position: Deferral Is Required Regardless of Different Entity

The authors strongly believe that the department's position is flawed on both technical and policy grounds. First, the department has no authority to deviate from a taxpayer's gross business profits as reported for federal income tax purposes without a statutory adjustment permitting it to do so. RSA section 77-A:1, III; RSA section 77-A:4.[7] The BPT statute simply does not permit an addback of gain deferred under section 1031, and the department's position expands the tax base in a manner not authorized or contemplated by the legislature. A direct addback statute for deferred gain would likely meet resounding and stiff opposition in the legislature, even during difficult fiscal times. States can expand the tax base by addback statutes, antileakage provisions, or other means, but that should be a clear legislative choice and should be expressly identified so that traps for the unwary do not arise. We further disagree that the separate business organization treatment under the BPT trumps the federal conformity provision, somehow providing the department with the implicit authority to recalculate gross business profits for BPT purposes.

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Second, we disagree that the BPT's separate business organization treatment defeats deferral — use of a SMLLC and separate business organizations still results in a valid like-kind exchange for BPT purposes under applicable federal tax authorities. There is ample authority in the federal tax system validating section 1031 deferral in transactions undertaken by separate taxpayers when there

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[5]Like many states, New Hampshire generally begins with Line 28 income or its equivalent in computing the tax base.

[6]Although the BPT is imposed on separate business organizations, it nonetheless requires that business organizations that are engaged in a unitary business file a combined return. The department's position would also apply in the combined return context. The department's position can best be understood as a revision of the tax base.

[7]RSA section 77-A:1, III defines gross business profits and RSA section 77-A:4 identifies additions and deductions to gross business profits in determining taxable business profits.

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is sufficient continuity of economic and management interests in the relinquished property and the replacement property. This federal line of cases is often referred to as the "swap and drop" (or "drop and swap") authority. In applying these federal rules to the BPT system, if Company A and the SMLLC were treated as separate taxpayers in the federal tax system — and they are not — section 1031 would still apply to defer the gain. Thus, even accepting the department's separate business organization position, Company A should still be entitled to gain deferral under section 1031. The department has not responded to the "swap and drop" authority to date, indicating either that it has either not fully explored the federal authority in this area or that the swap and drop authority represents a substantial litigation hazard for the department that it does not wish to acknowledge.

Third, the department's denial of tax deferral for valid section 1031 transactions that involve the use of disregarded entities represents flawed tax policy for the following reasons:

- There is no policy sense in creating substantial state tax obligations when a taxpayer has not received any cash and has explicitly deferred recognizing gain;
- The department's position discourages real estate development in New Hampshire at a critical time and reduces New Hampshire's competitiveness versus other states;
- The department has not detailed its position preaseeesement or postassessment in any public guidance, which reduces transparency and imposes substantial costs on taxpayers who cannot reasonably have expected that the statute would be interpreted in such a manner and who could have legitimately structured the transaction in a manner to avoid this tax result;[8]
- As discussed in note 1, the department's position imposes an unreasonable administrative burden on taxpayers engaging in valid section 1031 transactions, including the requirement that the taxpayer must track a different basis in the property for New Hampshire purposes; and
- A taxpayer's BPT payments on such transactions would not result in tax relief or basis credit in any other state so that when the replacement property is ultimately sold, the taxpayer would be double taxed on the same gain.

Those policy concerns take on even greater strength because the interposition of the SMLLC is often at the insistence of a third-party lender and is commonplace in the industry. In that respect, the department's position disregards the practice of the marketplace and serves to influence business practice in defiance of the principle of tax neutrality.

How to Respond to Department's Settlement Proposal? Walk Away!

In April 2009 the department made a verbal proposal that it intended to offer "settlements" in section 1031 audits by accepting 100 percent of the tax assessed (therefore effectively abating all interest and penalties). None of the section 1031 audits has yet reached an independent tribunal for consideration.

For the reasons stated in this article, the authors encourage affected taxpayers to reject the department's settlement proposal and push forward. A settlement resolution for 100 percent of the tax substantially overvalues the department's legal position, which we believe is flawed on many tax technical and policy grounds. ✰

[8]As discussed in note 1, the department's position in those cases is without explicit authority from the legislature and exposes the department to additional legal risk because New Hampshire law requires construing ambiguous tax statutes against the state rather than the taxpayer.. *See In re Denman*, 419 A.2d 1084, 1087 (N.H. 1980).

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