COMMENTS CONCERNING OPEN ISSUES IN SECTION 1031 LIKE-KIND EXCHANGES

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committees on Sales, exchanges and Basis and on Real Estate of the Section of Taxation. Principal responsibility was exercised by Louis S. Weller and Adam M. Handler. Substantive contributions were made by Michael L. Cook, Joe Vaulx Crockett III, Francesco A. Ferrante, Lewis M. Horowitz, Howard J. Levine, Ronold P. Platner, David Shechtman, Ronald A. Shellan, Charles M. Thompson and Mary Foster Vrbanac. The Comments were reviewed by Richard E. Marsh, Jr. of the Section's Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in the preparation of this report necessarily have clients affected by federal taxation, including the federal tax rules applied in the subject areas addressed by this report, no such member (or the firm of such member) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matters of these Comments.

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INTRODUCTION

Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code"), /1/ provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like kind which is to be held either for productive use in a trade or business or for investment. This provision has remained largely intact since the earliest years of the income tax and has spawned numerous court cases defining its core concepts: (1) what is an exchange; and (2) what is like-kind property?

Section 1031 was amended in 1984 to allow deferred exchanges under narrowly defined conditions and again in 1989 to restrict exchanges between related persons or involving non-U.S. real property. A smaller change, applying to partnerships electing out of Subchapter K under Code Section 761(a), was made in 1991. Also in 1991 Final regulations were issued covering deferred exchanges and exchanges of multiple and personal property. In 1992, regulations covering deferred exchanges and installment sales were proposed. Despite this relatively recent flurry of activity, a number of interpretive issues remain unclear.

The purpose of this Report is to propose answers to a number of open questions which we have identified. The list is not exhaustive and does not include several areas in which reports have been issued. /2/ Nevertheless, it is our hope that this report will help the Internal Revenue Service (the "Service") to create priorities and issue guidance addressing areas of concern to taxpayers attempting to understand and either qualify under or avoid mandatory application of Section 1031.

We believe that like-kind exchanges under Section 1031 are undertaken regularly by taxpayers of relatively modest means. Our experience indicates that the most common use of Section 1031 is the exchange of a small rental property. As a result, there is a need for practical guidance. The recent regulations published by the Service under Section 1031 have shown that the Service understands this need and we hope that future guidance continues in the same vein. A majority of the issues discussed in this Report represent questions which arise in everyday practice but which have not been definitively resolved by published guidance.

QUESTIONS AND ANSWERS

GROUP A -- GENERAL ISSUES

Q-1. HOW DO YOU ACCOUNT FOR SELLING EXPENSES IN A LIKE-KIND EXCHANGE?

Q-1a. ARE SELLING EXPENSES TAXABLE AS BOOT?

A-1a. The only authorities dealing with the treatment of selling expenses are Rev. Rul. 72-456, 1972-2 C.B. 468, and G.C.M. 34895 (June 5, 1972). The ruling and the General

Counsel Memorandum indicate that cash received by a taxpayer in an exchange is offset by commissions paid in computing amount realized and gain recognized, and the amount of the commissions is also added in determining the basis of the replacement property. This guidance only deals with commissions, but we believe that its principles can be expanded to all selling and "exchange" expenses incurred in either the disposition of the relinquished property or the acquisition of the replacement property. Accordingly, any selling expenses paid out of the exchange balance would not result in taxable boot to the taxpayer. We believe that such expenses should include all those that are typically deducted by the seller from the gross sales proceeds in a taxable sale under Section 1001, or capitalized by a buyer and added to the basis of the property acquired under Section 1012. Such expenses typically include commissions, finder's fees, inspection and testing fees, title insurance premiums, escrow fees, transfer taxes, recording fees and legal fees. These expenses will be referred to as "selling expenses."

Expenses such as the proration of rents, property taxes, utilities and property insurance premiums debited against the taxpayer out of the exchange balance are not selling expenses and should be taxable as ordinary income to the taxpayer outside of the Section 1031 rules to the extent they are not netted against amounts credited to the taxpayer for these items. If there is a net credit for these amounts that is used to acquire replacement property, such credit should, additionally, be treated as cash paid by the taxpayer and thus either increase the basis of the replacement property or reduce the gain recognized.

Loan fees, points, loan application fees, mortgage insurance, lender's insurance, assumption fees and other costs related to the acquisition of a loan for the replacement property should also not be treated as selling expenses because these costs generally are treated as part of the cost of obtaining a loan rather than the cost of obtaining the property, and do not increase the basis of the replacement property. Therefore, if those loan-related expenses are paid out of the exchange balance, they should constitute taxable boot in the form of cash received by the taxpayer. These expenses can, however, be offset by cash boot paid by the taxpayer and would be amortized over the term of the loan.

Q-1b. HOW SHOULD EXCHANGE RELATED INTERMEDIARY AND ESCROW OR TRUSTEE FEES BE TREATED?

A-1b. These fees are directly related to the exchange and therefore should be treated the same as other selling expenses under Q&A-1a.

Q-1c. WHEN CAN SELLING EXPENSES BE PAID FROM THE EXCHANGE BALANCE?

A-1c. In general, selling expenses can be paid at any time during the exchange period without affecting any of the safe harbors under Reg. section 1.1031(k)-1(g) if they are transactional items under Reg. section 1.1031(k)-1(g)(7); otherwise, they must be paid

in accordance with the limitations set forth in Reg. section 1.1031(k)-1(g)(6). We believe that all of the expenses described in Q&A-1a and Q&A-lb should be treated as transactional items under Reg. section 1.103(k)-1(g)(7).

Q-1d. HOW ARE THE RULES FOR SELLING EXPENSES COORDINATED WITH THE MULTIPLE-PROPERTY EXCHANGE RULES?

A-1d. The multiple-property exchange rules do not address the allocation of selling expenses among the assets. For consistency purposes, selling expenses could be treated similarly to liabilities under the multiple-property exchange regulations. Selling expenses relating to a particular item of property could be specially allocated to that property's exchange group. This alternative would have the advantages of allocating gain and basis consequences of the expenses to the property to which they most closely relate. Expenses that relate to the exchange as a whole could be allocated among exchange groups, but not to the residual group, in proportion to the aggregate fair market value of the relinquished properties.

As an alternative, selling expenses could be allocated among exchange groups, but not to the residual group, in proportion to the aggregate fair market value of the relinquished properties. Selling expenses would then reduce the value of the relinquished property in each exchange group to determine whether there is an "exchange group surplus" or an "exchange group deficiency." This would have the effect of reducing any gain realized and recognized within any exchange group by the amount of the deductible selling expenses allocated to that exchange group.

Q-2. WHAT ARE THE CONSEQUENCES OF REFINANCING BEFORE AND AFTER EXCHANGES?

A-2. The issue created by refinancings is whether proceeds received by a taxpayer which exceed existing debt encumbering relinquished property prior to an exchange or debt encumbering replacement property immediately following an exchange constitute "boot." The analysis is somewhat different for pre-exchange and post- exchange refinancings.

A-2a. PRE-EXCHANGE REFINANCINGS.

Existing authority indicates that where a preexchange refinancing is completed as part of an integrated transaction which includes the exchange, cash received by a taxpayer from a lender will be treated as cash received on disposition of the relinquished property. See, e.g., Long v. Commissioner, 77 T.C. 1045 (1981). Assume that A is transferring unencumbered Property 1 (worth $200X) in an exchange with B, who will transfer encumbered Property 2 (worth $200X, encumbered by a $100X mortgage). As part of the exchange, but immediately prior to conveying title to Property 1, A obtains a new $100X loan secured by Property 1. A and B exchange and each takes subject to (or assumes) the loans encumbering the properties. In effect A has "cashed out" in the amount of $100X, but if the rules of Reg. section 1.1031(b)-1(c) are strictly construed, A

has recognized no gain since A took Property 2 subject to debt which equaled the debt relief obtained. See, e.g., Fredericks v. Commissioner T.C. Memo 1994-27 CCH Dec 49,629 (M).

Notwithstanding this apparent rule, the Service is likely to assert that A has recognized gain of $100X because the cash received from the refinancing should be viewed as part of the consideration given by B on acquisition of Property 1. This principle is sometimes referred to as the "in anticipation of exchange" concept. The Service attempted formally to include this concept in the Section 1031 regulations by proposing an amendment to Reg. section 1.1031(b)-1(c) in 1990 and referring to this as a clarification of existing law. However, protests from practitioners and the public led the Service to conclude the proposed rule "could create substantial uncertainty in the tax results of exchanges." The proposal was withdrawn in the final regulations adopted in 1991. Although the proposal was withdrawn, the Service has not formally stated whether it still adheres to the proposition. This was its position in Fredericks, cited above.

Where a pre-exchange refinancing is clearly part of the exchange, doctrines such as step-transaction and substance over form should be sufficient to allow the Service to prevent taxpayers from receiving cash upon transfer of relinquished properties without having the cash treated as non-like kind property. We do not believe that a bright line test defining a specific period of "taint" for pre-exchange financings should be adopted. From a policy perspective, the key distinction should be whether the taxpayer ever bore the risk of repayment of a debt so as to permit the normal non-realization treatment of refinancing transactions. /3/ If the debt "came to rest," i.e., became the taxpayer's liability for more than the time needed to close subsequent parts of an exchange, then the usual non- realization treatment should apply and the existing boot-netting rules should apply to the debt. Thus, "true" refinanced debt will be offset either by debt assumed or taken subject to or by cash paid by the taxpayer. From the taxpayer's perspective, this means that refinancings should occur as separate, independent transactions from the exchange. Another factor, considered in the Fredericks case, is whether the refinancing occurs for reasons independent of the exchange, such as pending maturity of debt. Refinancing should not be conditioned on completion of a relinquished property transfer nor should it be part of the same escrow or settlement process. If credit evaluation is involved, it should be the taxpayer's credit, not the relinquished property acquirer's credit which is relevant.

A-2b. POST-EXCHANGE REFINANCINGS.

Post-exchange refinancings should be of less concern from a tax perspective than pre-exchange refinancings. Here the integration of the refinancing with the acquisition of replacement property should not matter. Even where a new loan is obtained at the time or immediately following a taxpayer's acquisition of replacement property in an exchange, receipt of cash by the taxpayer should not be treated as boot.

There is, however, virtually no authority addressing this issue. The key to the distinction between pre- and post-exchange refinancings is that the taxpayer will remain

responsible for repaying a post-exchange replacement property refinancing following completion of the exchange whereas the taxpayer by definition will be relieved from the liability for a pre-exchange relinquished property refinancing upon transfer of the relinquished property. A fundamental reason why borrowing money does not create income is that the money has to be repaid and therefore does not constitute a net increase in wealth. This is clearly the case in a post-exchange refinancing and there is no analytic reason to characterize such financings as being in lieu of fictitious payments by the seller of replacement property. Thus, we encourage the publication of a revenue ruling which indicates that money received in a post-exchange refinancing will not constitute "boot" in an exchange.

Q-3. HOW DO THE LIABILITY NETTING RULES WORK WHEN THE LOAN ON A RELINQUISHED PROPERTY IS PAID OFF AND A NEW LOAN IS OBTAINED TO FINANCE THE ACQUISITION OF THE REPLACEMENT PROPERTY?

A-3. The existing regulations have long provided that consideration received in the form of an assumption of a liability (or a transfer of property subject to a liability) is to be treated as "other property or money" (a/k/a "boot") for purposes of Section 1031(b). Reg. section 1.1031(b)-1(c). However, where each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, the so-called "liability netting rule" provides that consideration given in the form of an assumption of a liability or a receipt of property subject to a liability (or, for that matter, cash or other property) is offset against consideration received in the form of an assumption of a liability or a transfer of property subject to a liability. Under this rule, a taxpayer who receives boot (i.e., a taxpayer whose liability is assumed or who transfers property subject to liability) by surrendering property can offset the boot by any boot given, including cash, but a taxpayer who receives cash consideration (to equalize net values) cannot offset the cash boot received by boot given in the form of providing mortgage relief by assuming or receiving mortgaged property subject to existing debt. Reg. section 1.1031(d)-2, examples (1) and (2).

In many multi-party exchanges, whether simultaneous or deferred, the exchanging taxpayer will use proceeds from the first disposition to satisfy the liability attaching to the relinquished property. The same taxpayer will also borrow additional amounts to finance the acquisition of the replacement property. Thus, technically, no liabilities are "assumed" or "taken subject to." Analytically, the tax result ought to be the same regardless of whether the exchange involves (i) the relief from a liability attaching to the relinquished property netted against assumption of liabilities attaching to the replacement property or (ii) relief from a liability attaching to the relinquished property upon retirement of the liability using the buyer's funds followed by the creation of new indebtedness used to acquire replacement property. In fact, the Service has held that acquisition indebtedness incurred directly by the taxpayer is netted against liabilities relieved in the exchange because such indebtedness is treated either as liabilities assumed or cash paid by the taxpayer. TAM 8003004 (Sept. 19, 1979). See also Commissioner v. North Shore Bus Co., 143 F.2d 114 (2d Cir. 1944); Barker v. Commissioner, 74 T.C. 555, 568-569 (1980).

The tax consequences for simultaneous and deferred exchanges ought to be the same. The Service agrees that this is the case where debts on both the relinquished property and the replacement property are assumed. See Regulations section 1.1031(k)-1(j)(3), Example 5. However, the result is not entirely clear where relinquished property debt is retired and new financing is obtained on replacement property because Reg. section 1.1031(d)-1(c) literally requires that each party to the exchange either assumes a liability of the other party or acquires property subject to a liability. In a deferred exchange the buyer of relinquished property and the seller of replacement property typically have nothing to do with each other and an integrated escrow which conceptually ties them together is not required.

Despite the literal language of the cited regulation, the broader reading of the regulations evidenced in the TAM and the North Shore Bus and Barker cases is consistent with the purpose of the netting rule. Guidance should be issued, indicating that these concepts apply to all exchanges, whether simultaneous or deferred.

Q-4. HOW AND WHEN DO YOU COMBINE A LIKE-KIND EXCHANGE WITH A SECTION
1033 NONRECOGNITION REINVESTMENT TRANSACTION?

A-4. Section 1033 allows for gain to be rolled over if the taxpayer reinvests in qualifying property (and certain other conditions are met). There is, however, no requirement that an exchange be set up or that the cash proceeds be traced to the replacement property.

If a taxpayer desires to combine a like-kind exchange with a Section 1033 rollover, all that is necessary is for cash (or other property) to be added to the exchange balance. For example, Property 1 with an adjusted basis of $10,000 is transferred under threat of condemnation on January 10, 1994, and Taxpayer receives $100,000 of condemnation proceeds. On February 14, 1994, Taxpayer exchanges Property 2 (which has an adjusted basis of $25,000) and $100,000 cash for Property 3. Provided that Property 3 is both of a like kind to Property 2 and similar or related in service or use to Property 1 (taking Section 1033(g) into account), then, at the election of Taxpayer, Property 3 either has a basis of $35,000 and both the Section 1031 and 1033 gain has been rolled over, or a basis of $125,000 and then Section 1033 rollover is still available with respect to another property. This results from the mandatory application of Section 1031 contrasted to the elective character of deferral under Section 1033. The taxpayer may choose to defer the election until another property is acquired within the periods allowed by Section 1033(a)(2)(B)(i) or 1033(g)(4).

Q-5. IS A LEASEHOLD OR UNDIVIDED INTEREST IN PERSONAL PROPERTY OF A LIKE KIND WITH OUTRIGHT OWNERSHIP?

A-5. Yes. An undivided interest in personal property is of a like kind with outright ownership. Whether a leasehold interest in personal property is of a like kind with outright ownership depends on the facts and circumstances. In general, so long as the lease is for substantially all (i.e. more than 80%) of the remaining useful life of the

personal property, the leasehold interest should be of a like kind with outright ownership.

Q-6. WHEN ARE LEASEHOLD IMPROVEMENTS OF A LIKE KIND WITH FEE INTERESTS IN REAL ESTATE?

A-6. Provided that the leasehold improvements are treated as real property under local law, they should be of a like kind with land or any other real property interest. See Reg. section 1.1031(a)- 1(b). However, if the leasehold improvements are subject to an underlying land lease which has a remaining term of less than 30 years, then they will generally not be of a like kind with land (although they may still be of a like kind with other improvements). See Reg. section 1.1031(a)-1(c).

Q-7. HOW DO THE SECTION 1245 AND 1250 RECAPTURE RULES APPLY IN THE CASE OF AN EXCHANGE OF MULTIPLE PROPERTIES?

A-7. The answer is unclear. The multiple property exchange rules of Reg. section 1.1031(j)-1 are computational rules that are meant to simplify the basis and gain computations for such exchanges. They do not purport to modify the existing rules and make no reference to either Section 1245(b)(4) or Section 1250(d)(4) (which provide the rules for the recognition or deferral of recapture income in the case of a like-kind exchange where the relinquished property consists of either Section 1245 or Section 1250 property).

In the absence of guidance, taxpayers could use one of three methods for determining recapture income in the case of a multiple property exchange: (1) a property-by-property basis; (2) an exchange group basis; or (3) an exchange group basis with adjustments.

The first method should be rejected. It would require recapture computations that are completely separate from the basis and gain rules for multiple property exchanges and thus could lead to inconsistent results. It would also be inconsistent with the underlying theory of the multiple property exchange rules which is to match up properties so as to reduce the amount of gain recognized.

Applying Sections 1245(b)(4) and 1250(d)(4) on an exchange group basis would be both relatively easy and consistent with the multiple property exchange rules. With respect to each exchange group, the taxpayer would apply the recapture rules immediately after determining the amount of gain recognized with respect to the exchange group. The total recapture income recognized on the exchange would then be the sum of the amount recognized with respect to each exchange group (and the residual group). The amount of deferred recapture income would then be allocated among the properties received in the exchange group, in accordance with the relative fair market values of the Section 1245 or Section 1250 property (as the case may be) received in such exchange group.

The third method offers a further refinement. Under this method, if insufficient Section 1245 or 1250 property were received in a particular exchange group, taxpayers could look to other exchange groups with Section 1245 or 1250 property and reapply the recapture rules.

Although the third method results in the least amount of current taxation, we believe that it would be overly complex. Both the recapture rules and the multiple property exchange rules are already quite complicated and their interaction should be made as simple as possible. For these reasons, we believe that the Service should publish guidance adopting the second method and thus apply the recapture rules on an exchange group basis.

Q-8. MAY A LIKE-KIND EXCHANGE BE USED TO DEFER GAIN WHICH WOULD OTHERWISE BE RECOGNIZED ON FORECLOSURE OF PROPERTY WHICH IS SUBJECT TO A MORTGAGE WHOSE UNPAID PRINCIPAL AMOUNT EXCEEDS THE PROPERTY'S ADJUSTED BASIS AND ITS FAIR MARKET VALUE?

A-8. Yes. The issue is whether it is possible to exchange property in which the taxpayer has no "equity." A typical structure would involve transfer of an encumbered property to a qualified intermediary immediately prior to its sale at the lender's foreclosure auction. The intermediary would receive no proceeds from this sale and would not be obligated to spend any funds to acquire replacement property, but would be required to acquire replacement property subject to existing debt equal to the foreclosed debt, if the taxpayer could identify such property. The taxpayer would have the normal Section 1031(a)(3) time periods to identify and complete acquisition of replacement property.

There is nothing intrinsic about "equity" which relates to qualification of an exchange under Section 1031. Well established rules determine the amount realized on disposition of encumbered property: either the full amount of the debt (where the debt is non- recourse) or the fair market value of the property (where the debt is recourse). The relinquished property is not valueless; its value is pledged to secure a debt which exceeds the value. The normal recognition and non-recognition rules of Section 1031(b) and the Regulations work regardless of outside value, although in the case of recourse debt the undersecured portion may still result in net cancellation of indebtedness income to the taxpayer under the principles of Rev. Rul. 90-16, 1990-1 C.B. 12.

As a practical matter, the taxpayer attempting to utilize a like-kind exchange to defer income which otherwise would be recognized on a foreclosure would have to take on debt of equal or greater magnitude or put up the taxpayer's own capital in order to create offsetting boot given in the exchange. If the taxpayer is able to do so in a manner which is not a sham, there seems to be no policy reason to treat a "workout" driven exchange differently from any other exchange.

GROUP B -- DEFERRED EXCHANGES

Q-9. WHEN ARE TWO OR MORE EXCHANGES PART OF THE "SAME EXCHANGE" FOR
THE PURPOSES OF THE DEFERRED EXCHANGE REGULATIONS?

A-9. This would depend on the facts and circumstances of each situation. Neither the Code nor the existing regulations provide clear guidance. There are a number of factors which should be considered, including intent of the taxpayer, character of the relinquished properties, structure of the transactions, identity of the parties and timing.

Q-9a. WHAT PROBLEMS ARISE FROM HAVING TWO OR MORE EXCHANGES TREATED AS THE SAME EXCHANGE?

A-9a. A taxpayer may increase the number of replacement properties which may be identified by using multiple exchanges. For each separate exchange regardless of the number of relinquished properties, multiple replacement properties may be identified under the three-property rule or 200 percent rule of Reg. section 1.1031(k)-1(c)(4). However, if the exchanges are determined to be the "same exchange," the result may be that the taxpayer may violate the identification rules by identifying an excess number (or value) of replacement properties. This will have the effect of disqualifying the exchange except where some replacement properties are acquired within the identification period. Splitting the exchange into multiple exchanges can reduce these timing problems.

Also, where multiple relinquished properties are exchanged, either for single or for multiple replacement properties, timing problems may arise either in identifying or completing acquisition of all the replacement properties within the identification or exchange period (as deemed in Reg. section 1.1031(k)-1(b)(2)). If there is a single exchange, the identification period and exchange period commence on the date the first relinquished property is transferred. It may be difficult or impossible to satisfy the identification requirements if, for example, transfers of multiple relinquished properties which are more than 45 days apart are treated as part of the same exchange.

In addition, whether or not the multiple property exchange rules of Reg. section 1.1031(j)-1 apply may depend on whether there is a single exchange instead of multiple exchanges. Taxpayers need to know whether these rules apply, particularly where the allocation of excess liabilities assumed among exchange groups may be required under Reg. section 1.1031(j)-(b)(2)(ii)(B).

Q-9b. IS INTENT TO CREATE TWO OR MORE EXCHANGES A FACTOR?

A-9b. Yes. This intent can be documented by using separate exchange agreements, one for each exchange.

Q-9c. WILL SEPARATE EXCHANGE AGREEMENTS ALWAYS BE SUFFICIENT TO ESTABLISH SEPARATE EXCHANGES?

A-9c. Not always. The underlying facts may nevertheless indicate that there was really only a single exchange which was attempted to be converted in multiple exchanges by the use of multiple exchange agreements. Other factors may include use of the same escrow or settlement agent, transfer to the same purchaser, initial use of a single purchase/sale contract for multiple properties, and character of the properties (e.g., interdependence of two adjacent parcels being transferred to the same buyer). However, use of separate exchange agreements for exchanges of noncontiguous properties to different acquirers should generally be sufficient to establish that the exchanges are separate.

Q-9d. DO MULTIPLE RELINQUISHED PROPERTIES INDICATE MULTIPLE EXCHANGES?

A-9d. Where there are multiple relinquished properties, the taxpayer should be able to enter into multiple exchanges, one for each relinquished property. For example, if there are three relinquished properties, the taxpayer, under most circumstances, would be permitted to undertake a separate exchange with respect to each relinquished property. To do so, the taxpayer should execute a separate exchange agreement with respect to each such property. If the exchange is a deferred exchange, and if the proceeds from sale of the relinquished properties will be held in escrow or trust, there should be separate qualified escrows or trusts with respect to each exchange undertaken. It is not necessary that a separate qualified intermediary be utilized for each exchange, provided that each exchange is treated and accounted for separately and, if a qualified escrow or trust arrangement is used, the funds in each exchange are held in a separate escrow or trust.

Q-9e. WHAT ARE THE FACTORS FOR DETERMINING WHETHER THERE ARE MULTIPLE RELINQUISHED PROPERTIES RATHER THAN A SINGLE RELINQUISHED PROPERTY?

A-9e. Generally, properties in different locations which are not contiguous to one another and which can be separately described will be treated as different properties. Two adjacent lots or parcels which are subdivided and can be conveyed and used separately and independently of each other will be deemed separate properties. For example, two adjacent lots, each containing improvements consisting of a duplex, and each of which can be conveyed separately to separate buyers by separate deeds, will constitute separate relinquished properties. However, if there are two such lots with improvements consisting of one building situated partly on one lot and partly on the other, the lots will not constitute separate relinquished properties because the use of one property is dependent upon the use of the other. Similarly, if one lot contains improvements such as a restaurant or office building, and an adjacent lot contains a parking lot which can be used solely in connection with the adjacent restaurant or office building and not independently (either because of restrictive covenants, because of

physical limitations on the use of that parking lot such as access, or because the parking lot provides the sole source of parking which is necessary for the other lot) then such properties will constitute a single relinquished property.

The rules described above will be easy to apply and fair in the majority of cases. However, taxpayers should also be permitted to treat separate legal lots as a single property. For example, an apartment building should be permitted to be treated as a single property even if it has been condominiumized. Similarly, contiguous parcels should be permitted to be treated as a single property. /4/

Q-9f. DOES THE FACT THAT MULTIPLE RELINQUISHED PROPERTIES ARE EXCHANGED FOR A SINGLE REPLACEMENT PROPERTY INDICATE THAT THERE WAS ONLY A SINGLE EXCHANGE?

A-9f. If each exchange involved separate relinquished properties, utilized a separate exchange agreement and a separate escrow or trust for holding the exchange proceeds, and were otherwise treated as a separate exchange, the fact that a single property is used as the replacement property for each relinquished property will not cause the separate exchanges to be treated as a single exchange. In such a case, the single replacement property must have been properly identified as such in each of the separate exchanges.

Q-9g. WILL THE FACT THAT THE TWO PROPERTIES ARE ENCUMBERED BY A SINGLE MORTGAGE OR DEED OF TRUST PRECLUDE UTILIZING THOSE PROPERTIES AS SEPARATE RELINQUISHED PROPERTIES IN SEPARATE EXCHANGES?

A-9g. No. Provided that (A) the two properties are of such a character that they can be separately exchanged, and (B) the exchange is properly structured through separate exchange agreements and adherence to other requirements for non-recognition under Section 1031, the fact that they are encumbered by a single mortgage will not require that they be aggregated into a single exchange.

Q-9h. IF A TAXPAYER HAS SET UP A SINGLE EXCHANGE AS TO TWO OR MORE RELINQUISHED PROPERTIES AND HAS EXECUTED AN EXCHANGE AGREEMENT WITH RESPECT TO THAT EXCHANGE, MAY THE TAXPAYER LATER CONVERT THE TRANSACTIONS INTO TWO OR MORE EXCHANGES?

A-9h. Yes, provided that each of the exchanges would otherwise qualify as separate exchanges. In such a case, the conversion into separate exchanges may be made by a written amendment to the exchange agreement setting forth the fact that the single exchange is to be separated into more than one exchange and otherwise modifying the exchange agreement so as to treat the exchanges as separate. The amendment must be executed on or prior to the date that the first relinquished property is transferred.

Q-9i. IF TWO OR MORE TAXPAYERS OWN A SINGLE RELINQUISHED PROPERTY AS TENANTS IN COMMON, UNDER WHAT CIRCUMSTANCES WILL THEY BE TREATED AS ONE TAXPAYER ENGAGING IN A SINGLE EXCHANGE?

A-9i. Only under circumstances showing a clear intent to be treated as one taxpayer will co-owners be treated as such. Otherwise, the nature of the ownership of the property will control. The multiple taxpayers may have entered into a partnership agreement through which they account for profit and loss from the property, take depreciation and other property-related deductions, and file partnership tax returns showing the property as a partnership asset. Such factors may be an indication that the owners intend the property to be held by a partnership. It should be noted, however, that it is possible for land to be held and owned by individual co-owners (and income and expenses accounted for separately by the co-owners), and for the improvements thereon to be owned by a partnership (in income, expenses, depreciation, etc. accounted for separately by the partnership). Such a situation would require two separate exchanges, one as to the land and the other as to the building.

Q-10. DO THE THREE-PROPERTY AND 200-PERCENT IDENTIFICATION RULES APPLY ON AN EXCHANGE GROUP BY EXCHANGE GROUP BASIS IN THE CASE OF A MULTIPLE PROPERTY EXCHANGE?

A-10. No. Reg. section 1.1031(k)-1(c)(4) provides that the three-property and 200-percent rules apply "[r]egardless of the number of properties transferred by the taxpayer as part of the same deferred exchange." Thus, so long as the multiple properties exchanged are exchanged as part of the "same deferred exchange," the three-property and 200-percent rules will apply to the multiple property exchange as a whole and not on an exchange group by exchange group basis.

The practical result is that in the case of a true multiple property exchange (or an exchange of a business), only the 200- percent rule can be used. It should be noted, however, that most real estate exchanges which also happen to be multiple property exchanges (due to the inclusion of small amounts of personal property) can still use the three-property rule if the identified replacement properties satisfy the incidental property rule contained in Reg. section 1.1031(k)-1(c)(5).

Q-11. WHAT IS THE RELEVANT TEST, WITH RESPECT TO REAL ESTATE THAT IS NOT TO BE PRODUCED, TO DETERMINE WHETHER THE ACTUAL REPLACEMENT PROPERTY IS "SUBSTANTIALLY THE SAME PROPERTY AS IDENTIFIED" UNDER REG. SECTION 1.1031(k)-1(d)(i)?

A-11. In order to be considered "substantially the same property as identified," for purposes of Reg. section 1.1031(k)-1(d)(i), the following safe harbor test should be adopted: (A) either the replacement property must be part of the property that was identified, or the identified property must be part of the replacement property; (B) the fair market value of the replacement property on the date of receipt should be no less than 75 percent, -- nor more than 125 percent, of the fair market value of the identified

property on the date of identification; and (C) the "nature and character" of the replacement property, as that phrase is used in Reg. section 1.1031(a)-2(b), must be the same as that of the identified property. /5/ The reason for adopting a safe harbor approach rather than a bright line test is to account for the possibility that replacement properties which fall outside the 75 percent/125 percent value test will still be, for practical purposes, "substantially the same" as identified.

Q-12. WHAT IS THE SCOPE OF LEGAL SERVICES THAT CAN BE RENDERED UNDER REG. SECTION 1.1031(k)-1(k)(2)(i) WITHOUT AN ATTORNEY BECOMING A "DISQUALIFIED PERSON"?

A-12. If an attorney has provided legal services unrelated to like-kind exchanges within two years prior to an exchange, then under Reg. section 1.1031(k)-1(k)(2), the attorney is a disqualified person.

An attorney who has not previously represented the taxpayer should be able to provide services that relate to the disposition of the relinquished property. These services would be those that would normally be associated with the disposition of property which is of a like kind to the relinquished property. In the context of real estate, this would include negotiation of the sale and exchange agreement on behalf of the taxpayer, the clearing of title issues, the resolution of other real property and financing issues which directly relate to the disposition of the property, rendering tax advice on the disposition and any other activity which directly relates to the disposition of the relinquished property.

In addition, the attorney should be able to provide legal services that relate to the acquisition of the replacement property. For real estate, these services would include the negotiation of an acquisition or exchange agreement for the replacement property, the ordering of title insurance or attorney's title opinion, providing an opinion of title, negotiating financing, negotiating with existing tenants to secure estoppels, subordinations to financing and extensions of leases, preparation of documents that directly relate to the acquisition or financing of the replacement property, attending settlement or engaging in the closing of the escrow, providing tax advice and assistance, clearing title and negotiating any additional real property concerns which must be addressed to effectuate the sale.

These disposition and acquisition issues are clearly delineated as services performed in conjunction with the exchange and these services would not be performed unless the exchange were taking place. Acquisition services within the contemplated scope of permitted "exchange related" services would not include representing the taxpayer in obtaining subdivision or zoning approval which may be a condition of acquisition, since this goes well beyond the scope of acquisition.

Services performed that are outside the scope of the disposition and acquisition of real estate, such as representation in the purchase or sale of a business unrelated to the real property exchange would be construed as providing legal services outside the

scope of representation for the disposition and acquisition of real property and, therefore, would result in the attorney being a disqualified person.

Services provided by an attorney for the disposition and acquisition of real property in an exchange would not disqualify the attorney from representing a party in the same or similar capacity in connection with other property(s) to be exchanged, even if provided within a two-year period prior to the newest exchange transaction. The attorney, under these circumstances, could provide the same or other permitted services as rendered in the previous transactions. Any other legal services rendered by the attorney during the two-year period following representation in the disposition and acquisition of exchange property would disqualify that attorney from acting as the intermediary in a subsequent transaction.

Q-13. WHAT IS THE SCOPE OF "ROUTINE FINANCIAL, TITLE INSURANCE, ESCROW, OR TRUST SERVICES" THAT CAN BE RENDERED UNDER REG. SECTION 1.1031(k)-1(k)(1)(ii) WITHOUT THE PERSON BECOMING A "DISQUALIFIED PERSON"?

A-13. Any services rendered in the ordinary course of business of a bank, thrift, title insurance company, escrow company, trust company or other entity entitled to serve as a qualified escrow, trust or intermediary will be "routine" for purposes of this section of the Regulations. Ms means that banks can have depositor and creditor relationships with a taxpayer and still serve as the taxpayer's intermediary; title insurance companies are not precluded from serving despite having written title insurance in favor of a taxpayer, escrow companies may serve despite involvement in past or present escrows and so on. This provision is intended to recognize that the conduct of ordinary business between a taxpayer and a qualified escrow, trust or intermediary does not result in the taxpayer's gaining such control over the other party that the "independence" which the Regulations' safe harbors seek to assure is compromised.

The prohibitions against control or ownership of entities (Reg. section 1.1031(k)-1(k)(3) and -1(k)(4)) will serve to prevent most abuses which could arise in the case of institutions or entities for whom the "routine" services safe harbor is a question. There may be facts and circumstances involving special services provided to a taxpayer, clearly outside the ordinary course of business, which evidence an unusual degree of control by the taxpayer over the otherwise "qualified" entity or individual. The Service already has the authority to address such abuses under the "otherwise obtain the benefits" language of Reg. section 1.1031(k)-1(g)(6).

Q-14. MAY A TRUST OR ESCROW ACT AS A QUALIFIED INTERMEDIARY?

A-14. A trust may act as a qualified intermediary provided that the trustee of the trust is not a disqualified person and no beneficiary of the trust is a disqualified person. However, a qualified trust is merely a security device. Thus, a deferred exchange secured by a qualified trust will also need to involve an exchange between the taxpayer and the buyer of relinquished property or a qualified intermediary.

An escrow is a person who may only take actions specified in instructions to the escrow. An escrow is a security device and not a party to the transaction. Thus, a deferred exchange secured by a qualified escrow will also require an exchange between the taxpayer and the buyer of relinquished property or a qualified intermediary.

Q-15. IN A DEFERRED EXCHANGE, CAN THE TAXPAYER FUND THE EXCHANGE BALANCE WITH ADDITIONAL CASH DURING THE EXCHANGE PERIOD?

A-15. Yes. Any additional funds deposited during the exchange period will be treated as cash boot paid by the taxpayer and will not affect the safe harbors under Reg. section 1.1031(k)-1(g) because depositing additional funds does not result in actual or constructive receipt of the exchange balance during the exchange period. Funds may be deposited in a qualified escrow or trust, deposited with a qualified intermediary, or paid to the seller of replacement property directly or through a settlement agent.

Q-16. IN A DEFERRED EXCHANGE, HOW SHOULD THE INTEREST EARNED ON THE EXCHANGE BALANCE BE TAXED?

Q-16a. IN WHOSE ACCOUNT NAME AND TAXPAYER IDENTIFICATION NUMBER SHOULD THE ACCOUNT BE HELD?

A-16a. The agreement between the taxpayer and other parties to the exchange will determine the identity of any account in which funds representing an exchange balance is placed and held and the tax identification number associated with such account. So long as applicable agreements affecting the exchange (A) limit the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of any money or other property in such account to the circumstances provided in Reg. section 1.1031(k)-1(g)(6)(ii) or (iii) and (B) the exchange otherwise complies with the safe harbor requirements of Reg. section 1.1031(k)-1(g)(2), (3) or (4), then the use of the taxpayer's name or tax identification number on such account will be disregarded in determining whether the taxpayer is in actual or constructive receipt of money or property which is not of a like kind to the relinquished property.

Q-16b. WHAT IS THE PROPER WAY FOR A QUALIFIED INTERMEDIARY OR OTHER PARTY TO REPORT INTEREST INCOME TO THE TAXPAYER?

A-16b. If the qualified intermediary or other party (A) receives interest from a depository, (B) is obligated to pay a growth factor or interest equivalent to a taxpayer, (C) is not expressly identified as taxpayer's agent in applicable agreements between them, and (D) meets the requirements otherwise applicable to filing a Form 1099, the other party or qualified intermediary should file a Form 1099-INT with respect to each exchange in which a taxpayer receives interest income, showing the taxpayer as the recipient of the interest income.

Q-16c. WHEN SHOULD INTEREST INCOME ON AN EXCHANGE BALANCE BE REPORTED AS INCOME BY A TAXPAYER?

A-16c. The interest income should be reported by the taxpayer based on its normal tax accounting method. Thus, a cash basis taxpayer must report the interest income in the year it is actually or constructively received.

The first cash or non-qualified property a cash basis taxpayer receives will be deemed to include interest income to the extent of the interest earned on the exchange balance to the date of the receipt. If the cash or non-qualified property a taxpayer receives in the exchange is less than the interest income earned on the exchange balance, any remaining interest earned will be deemed received by the taxpayer on the termination of the exchange.

GROUP C -- ISSUES CREATED BY I.R.C. SECTION 1031(f) AND (g)

Section 7601 of the Omnibus Budget Reconciliation Act of 1989, Pub L. 101-239 restricted certain like-kind exchanges between related parties by adding Section 1031(f) and (g). This statutory change was prompted by the perceived abuse associated with "basis shifting" in related party exchanges of high basis property for low basis property in anticipation of the sale of the formerly low basis property. It also was feared that basis shifting could be used to accelerate a loss on the sale of the exchange property. Committee Reports accompanying the 1989 legislation state that a related party exchange followed shortly thereafter by a disposition of either exchange property should be viewed as the "cashing out" of an investment in like-kind property, such that the original exchange should not be accorded non-recognition treatment.

Section 1031(f) generally establishes a two-year holding period for like-kind property given or received in a like-kind exchange involving related persons. Section 1031(g) suspends the running of the two-year period during any period when an exchange party's risk of loss is substantially diminished through certain contractual arrangements, such as a put. Section 1031(f) also includes broad "anti-abuse" language intended to prevent taxpayers from structuring transactions in order to avoid the related party rules. The language of Section 1031(f) and (g) is modeled after similar provisions found in Section 453(e), which governs related party installment sales.

Q-17. WHERE A TAXPAYER AND A RELATED PARTY EXCHANGE PROPERTIES WHICH EACH OWNED PRIOR TO THE EXCHANGE AND WITHIN TWO YEARS THE RELATED PARTY SELLS THE PROPERTY IT ACQUIRED IN THE EXCHANGE, WHAT HAPPENS?

A-17. The exchange is not accorded nonrecognition treatment because the related party disposed of the relinquished property within two years after the property was acquired from the taxpayer. Both the taxpayer and the related party are required to recognize any gain realized in the exchange but only in the year in which the disposition of the property occurs.

Q-18. IS NONRECOGNITION TREATMENT LOST IF, FOLLOWING AN EXCHANGE OF PROPERTIES BETWEEN THE TAXPAYER AND A RELATED PARTY, THE RELATED PARTY SELLS THE RELINQUISHED PROPERTY PURSUANT TO A MARITAL DISSOLUTION DECREE?

A-18. Dispositions following death and certain other specific events are disregarded. See Section 1031(f)(2)(A). However, the existing list of categories of dispositions that are disregarded does not include a disposition occasioned by a divorce or other personal emergency. We believe, however, that any event constituting a genuine change in personal or commercial circumstances (such as a divorce) should be sufficient to establish that the disposition did not have as one of its principal purposes the avoidance of federal income tax. See Section 1031(f)(2)(C). The Service should illustrate the application of the non-tax avoidance safe harbor set forth in Section 1031(f)(2)(C) through published rulings or by promulgating a revenue procedure that would provide taxpayers with an opportunity to establish in advance the non tax-avoidance circumstances of a subsequent disposition.

Any disposition within the two-year period that is itself a nonrecognition transaction, e.g., another Section 1031 exchange, a Section 351 or 721 contribution, a Section 1041 transfer or a gift, should automatically satisfy the non tax-avoidance standard, as suggested in the Committee Reports.

Q-19. WILL A TAXPAYER BE ENTITLED TO RECOGNIZE A LOSS REALIZED WHEN THE BASIS OF RELINQUISHED PROPERTY TRANSFERRED BY THE TAXPAYER TO A RELATED PARTY IS GREATER THAN ITS VALUE AND THE RELINQUISHED PROPERTY IS SOLD BY THE RELATED PARTY PRIOR TO TWO YEARS FROM THE DATE OF THE EXCHANGE?

A-19. No. Application of Section 267 results in shifting the tax loss realized by a taxpayer to the related party. Section 267(a)(1) provides that no deduction will be allowed in respect to any loss from the direct or indirect sale of property between related persons. Consequently, even though the nonrecognition provisions of Section 1031 are inapplicable to the exchange because of the related party rule of Section 1031(f), the taxpayer is not allowed to recognize the realized loss. Instead, pursuant to Section 267(d), any gain that the related party subsequently realized upon the disposition of the received property is reduced to the extent of the unrecognized loss realized by the taxpayer.

Q-20. WHAT IS THE RESULT IF, IN A DEFERRED EXCHANGE, A TAXPAYER TRANSFERS RELINQUISHED PROPERTY TO A QUALIFIED INTERMEDIARY WHICH SELLS THE PROPERTY TO A RELATED PARTY FOR CASH AND SUBSEQUENTLY ACQUIRES REPLACEMENT PROPERTY FROM A PARTY NOT RELATED TO THE TAXPAYER AND TRANSFERS THE REPLACEMENT PROPERTY TO TAXPAYER?

A-20. Acquisition of relinquished property for cash from the qualified intermediary does not subject the exchange to the rules of Section 1031(f) even though the relinquished property is purchased by a related party.

Not every transaction "touched" by a related party is a related- party exchange. If the replacement property is never owned by a related party, its transfer to a taxpayer via a qualified intermediary should not be affected by a related party's purchase of relinquished property. There is no abusive basis shift because the related party's purchase involves creation of a new cost basis rather than a carryover.

Q-21. MAY A TAXPAYER ARRANGE FOR AN UNRELATED PARTY (INCLUDING A QUALIFIED INTERMEDIARY) TO ACQUIRE REPLACEMENT PROPERTY OWNED BY A RELATED PARTY AND COMPLETE AN EXCHANGE IN WHICH THE TAXPAYER'S RELINQUISHED PROPERTY IS TRANSFERRED TO THE UNRELATED PARTY OR INTERMEDIARY IN EXCHANGE FOR THE REPLACEMENT PROPERTY INITIALLY OWNED BY THE RELATED PARTY?

A-21. No. The Senate Finance Committee Report states that non- recognition treatment will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. The Senate Report further states that if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under Section 1031, the related party will not be entitled to non-recognition treatment under Section 1031. Here, the transaction is merely a rearrangement of the steps described in the Senate Finance Committee Report, and thus is covered by the antiabuse language of Section 1031(f)(4).

Q-22. WHERE A PARTY RELATED TO A TAXPAYER OWNS NO PROPERTY AT THE COMMENCEMENT OF AN EXCHANGE, BUT SERVES AS AN INTERMEDIARY IN THE EXCHANGE, WILL THE APPLICATION OF SECTION 1031(f) DENY NONRECOGNITION TREATMENT TO THE EXCHANGE BECAUSE THE RELATED PARTY HAS ACQUIRED AND TRANSFERRED PROPERTY IN THE EXCHANGE AS PART OF ITS ROLE AS INTERMEDIARY?

A-22. No. Section 1031(f)(2)(C) provides that the rule of Section 1031(f) will not apply to exchanges between related parties where there is no tax avoidance motive. Use of a related party intermediary does not result in any basis shift or other consequence which Section 1031(f) is intended to address. However, use of a related party as an intermediary will mean that the exchange falls outside the safe harbor for qualified intermediaries established by Reg. section 1.1031(k)-1(g)(4) since a party related for purposes of Section 1031(f) will be a disqualified person under Reg. section 1.1031(k)-1(k). Thus, the taxpayer may bear the burden of proof that the intermediary is not the taxpayer's agent or that the taxpayer is not otherwise in constructive receipt of proceeds from the sale of the relinquished property.

FOOTNOTES

/1/ Unless otherwise indicated, all statutory references are to sections of the Code.

/2/ These areas are: reverse exchanges, deferred exchanges and installment sales, exchanges involving foreign persons and the Section 752 and minimum gain chargeback consequences of exchanges by partnerships.

/3/ By risk of repayment, we do not mean to imply that the debt must be recourse, but merely that the lender expects the taxpayer (and not the acquirer of the relinquished property) to repay the debt.

/4/ Rules such as these are of more importance in the application of the three-property rule for identifications of replacement property.

/5/ Example 3 of Reg. section 1.1031(k)-1(d)(2) provides that, where the identified property was a barn and two acres of land and the received property consists of the barn and the underlying land, the taxpayer has not received substantially the same property as identified because what was identified differs in "basic nature or character" from what was received. However, pursuant to Reg. section 1.1031(a)-1(b), whether or not real estate is improved relates only to its grade or quality not its nature or character. This example should therefore be rewritten to change either its conclusion or the basis for its conclusion. (This example and example 4 also contain a math error which should be corrected.)